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A Diversity Theory of Charitable Tax Exemption—Beyond Efficiency, Through Critical Race Theory, Toward Diversity

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ARTICLES

A DIVERSITY THEORY OF CHARITABLE TAX EXEMPTION—BEYOND EFFICIENCY, THROUGH CRITICAL RACE THEORY, TOWARD DIVERSITY*

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INTRODUCTION

What is the normative rationale for the federal income tax exemption for nonprofit charitable corporations? Even though the exemption dates back to 1894,[1] Congress has failed to fully rationalize it.[2] Though scholars and courts have attempted over the years to come up with a coherent rationale for the charitable tax exemption, their attempts are focused almost exclusively on economic efficiency. Thus, the charitable tax exemption is typically framed by noted tax scholars like Boris Bittker, Henry Hansmann, and others as an economically efficient means of providing certain goods and services to the public.[3] Rationalizing the charitable tax exemption in economic terms is certainly appealing and deceptively comforting. Indeed, since taxation is facially concerned with money, why not articulate a basis for tax exemption in money terms—hence, economic efficiency.

But no matter how appealing efficiency might seem, it is axiomatic that law, and more particularly tax law, is about much more than economic efficiency. Tax law is about broader conceptions of justice, fairness, and other aspects of a democratic society that extend beyond economic principles.[4]

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1. *See* Revenue Act of 1894, ch. 349, § 32, 28 Stat. 509, 556; *see also* Revenue Act of 1909, ch. 6, § 38, 36 Stat. 11, 112; Revenue Act of 1913, ch. 16, § 2(G), 38 Stat. 114, 172.

2. *See* Boris Bittker & George Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Tax*, 85 YALE L.J. 299, 301–04 (1976) (concluding that the "legislative history of the tax exemption reveals no systematic analysis").

3. Most notable of the economic theorists is Henry Hansmann in his capital subsidy theory. *See* Henry Hansmann, *The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation*, 91 YALE L.J. 54 (1981). Other such theorists include Boris Bittker, Mark Hall, and John Colombo. *See* Bittker & Rahdert, *supra* note 2; Mark A. Hall & John D. Colombo, *The Charitable Status of Nonprofit Hospitals: Toward a Donative Theory of Tax Exemption*, 66 WASH. L. REV. 307 (1991) [hereinafter Hall & Colombo, *Charitable Status*]; Mark A. Hall & John D. Colombo, *The Donative Theory of the Charitable Tax Exemption*, 52 OHIO ST. L.J. 1379 (1991) [hereinafter Hall & Colombo, *Donative Theory*]. Hansmann's theory of exemption is particularly noteworthy because he positions his theory as an explicitly economic rationalization for the charitable tax exemption that accounts for the bulk of so-called "public goods" provided by charities. However, even Hansmann's broadly accepted economic theory of the charitable tax exemption has been challenged, principally on non-economic grounds. *See, e.g.*, Rob Atkinson, *Altruism in Nonprofit Organizations*, 31 B.C. L. REV. 501 (1990) [hereinafter Atkinson, *Altruism*]; Rob Atkinson, *Theories of the Federal Income Tax Exemption for Charities: Thesis, Antithesis, and Synthesis*, 27 STETSON L. REV. 395 (1997) [hereinafter Atkinson, *Theories*]; Nina J. Crimm, *An Explanation of the Federal Income Tax Exemption for Charitable Organizations: A Theory of Risk Compensation*, 50 FLA. L. REV. 419 (1998); Evelyn Brody, *Of Sovereignty and Subsidy: Conceptualizing the Charity Tax Exemption*, 23 J. CORP. L. 585 (1998).

4. For example, even though the federal estate tax burden is born almost exclusively by wealthy taxpayers, its temporary repeal has been promoted politically as, alternatively, an end to the death tax and

Likewise, the tax exemption for charities is about much more than money, economics, or optimal profit. Instead, the charitable tax exemption is principally about accomplishing a value-based mission. That mission may at times be at odds with the notion of a pure profit motive that dominates the private market narrative.[5] While efficiency analysis may be relevant to some aspects of a charitable mission, there are many other non-economic aspects of "mission" that extend beyond economics. Thus, this article does not dispute that traditional efficiency analysis adds to our normative understanding of tax-exempt charity law. Economic analysis may, for example, aid in understanding the exemption's economic impact. However, efficiency alone simply does not fully explain the varied and rich non-economic aspects of the charitable tax exemption. Accordingly, this article offers an alternative framing of the charitable tax exemption that serves as an alternative to the longstanding economic theories of scholars like Boris Bittker, Henry Hansmann, and others. The article demonstrates that a principal normative justification for the exemption, in addition to economic efficiency, is diversity—what this article calls "contextual diversity."

Part I of the article presents Robin Paul Malloy's Law and Market Economy Theory ("LMT") as an example of the basis for a normative explanation of the charitable tax exemption. LMT addresses the relationship among law, markets, and culture. Thus, using LMT, this part demonstrates how traditional law and economic analysis, premised on self-interest and wealth maximization, simply does not capture the essence of the many values that impact the marketplace and the market exchange process. Instead, LMT

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an end to a tax on small family farms. *See, e.g.*, Sarah E. Waldeck, *An Appeal to Charity: Using Philanthropy to Revitalize the Estate Tax*, 24 VA. TAX REV. 667, 695–96 (2005) (referring to the estate tax as the "death tax" and noting that aside from its aim of preventing high concentrations of wealth, the estate tax has many emotional components); *see also* David A. Brennen, *Race and Equality Across the Law School Curriculum: The Law of Tax Exemption*, 54 J. LEGAL EDUC. 336 (2004) (explaining how incorporation of concepts of race into legal disciplines such as tax law might enrich study of these areas).

5. In emphasizing the distinctive characteristics of non-profits, including tax-exempt charities, from for-profit organizations, Professor Robin Paul Malloy has explained:

> One can reasonably ask why it is that we provide special local, state, and Federal tax benefits to non-profits as opposed to private or for-profit organizations. . . . [M]any people believe it is important to do so because non-profits tend to supply *public goods*, the provision of which is usually under-provided in the private market. Furthermore, non-profits generally seek to promote values that are difficult to measure in economic terms. The non-profit framework, therefore, raises some important cultural-interpretive issues. The focus on values, and the rejection of a pure profit motive, are two very important points of divergence from the conventionalized norms expressed in our private market narratives.

ROBIN PAUL MALLOY, LAW IN A MARKET CONTEXT: AN INTRODUCTION TO MARKET CONCEPTS IN LEGAL REASONING 214 (2004) (emphasis in original).

approaches legal analysis in a broader market context and is premised on the need to promote a process of sustainable wealth formation as opposed to maximizing wealth. As an illustration of the difference between traditional law and economics and LMT, Part I addresses the way in which LMT is compatible with Critical Race Theory in discerning normative rationales for law that enable richer reflections of justice, fairness, and equality that are not necessarily connected to positive economics or efficiency.

Part II of the article presents a theory of the charitable tax exemption that is line with LMT and based on the value of diversity. "Contextual diversity," as explained herein, references alternative understandings of LMT to build on insights of traditional economic analysis and present an alternative value-based rationalization for the charitable tax exemption. Part II concludes by explaining that using contextual diversity as a principal value-based rationalization for the charitable tax exemption not only captures the essence of the exemption, but it also provides direction for potentially reforming and re-inventing various aspects of tax-exempt charity law.

Part III of the article provides a detailed outline of the charitable tax exemption—explaining both the affirmative and negative aspects of the exemption. The purpose of this detailed outline is to position the exemption as not simply a financial "free pass" on the obligation to pay income tax. Rather, the charitable tax exemption is the gateway to an alternative way of operating an enterprise, with many burdens and benefits flowing therefrom that often have nothing to do with economics or efficiency. Instead, these non-economic aspects of the charitable tax exemption often concern the many non-economic aspects of justice, fairness, equality, political authority, and other basic normative principles. Tax-exempt charities are not like private for-profit firms that measure success by bottom-line profits; nor are they like public entities that measure success by voter support or re-election. Tax-exempt charities measure success by how well their missions are accomplished. Measuring success in this way is inherently "more of a normative judgment than it is for a private entity" or a public entity "because there are fewer external market indicators available" for determining a charity's success.[6]

Part IV builds on Part I by demonstrating how the predominant traditional theories of charitable tax exemption just do not capture the full essence of the normative aspects of the exemption. Part IV analyzes the traditional theories promulgated prior to 1990 which rely principally on economic efficiency as

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6. *Id.* at 219–20.

a guidepost for discerning an appropriate rationale. While these traditional theories have a sexy "law and economics" appeal, the article demonstrates how they fail to fully explain many non-economic aspects of the charitable tax exemption.[7] Finally, Part V briefly identifies some of the implications of contextual diversity theory on the structure of tax-exempt charity law.

I. INTERSECTIONS OF ECONOMIC AND CRITICAL THEORIES OF LAW

LMT and its interplay with Critical Race Theory (CRT) is just one example of how different theoretical approaches to law can come together to partially expose important elements of a particular substantive area of law. Sub-part A outlines LMT—a theory of law that is based on economic principles, but which extends beyond traditional economic analysis to incorporate other humanistic values into an understanding of law and social interaction. LMT posits that law is more fully understood when economic analysis is combined with other approaches to legal analysis to demonstrate the dynamic and ever-changing aspects of human interaction. As one example of how other theories of law might complement economic understandings of the law, sub-part B demonstrates how CRT might be used as a means of understanding aspects of law that are not fully understood by economics alone. Overall, this section demonstrates how traditional understandings about economic analysis of law could be diversified by accommodating other approaches to law, such as CRT. Such accommodation could lead to better, more diverse understandings of the structure of tax-exempt charity law and potentially improve future development of this burgeoning area of law.

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7. This Article focuses primarily on the pre-1990 theories of charitable tax exemption because they tend to rely almost exclusively on notions of economic efficiency. In future research, I intend to examine theories promulgated since 1990 that challenge the pre-1990 traditional theories. These more recent theories of exemption challenge the traditional theories by focusing less on economic efficiency and more on non-economic values. They draw on notions of philosophy, political theory, and moral values as a means for complementing the traditional economics focus of the pre-1990 theories. Thus, these recent theories explain the charitable tax exemption from the perspective of the selflessness (as opposed to self-interest) of the donor, *see, e.g.*, Atkinson, *Altruism*, *supra* note 3; Atkinson, *Theories*, *supra* note 3, and the alternate political authority offered by the charitable form, *see, e.g.*, Brody, *supra* note 3. These other theories of the charitable tax exemption come closer to articulating the type of contextual diversity contemplated in this article. For they implicitly recognize that much of the justification for the charitable tax exemption is not about economic efficiency. Many aspects of the exemption concern notions of justice, fairness, and opportunity—concepts that are not necessarily translatable into economic or efficiency terminology. However, I intend to develop, in later research, the idea that even these theories do not fully account for the many complexities inherent in the charitable tax exemption.

A. Law and Market Theory—Sustainable Wealth

Traditional economic analysis of law is premised on the idea that efficiency leads to wealth maximization. Richard Posner, in his book *Economic Analysis of Law*, writes that: "economics is the science of rational choice in a world . . . in which resources are limited in relation to human wants."[8] This means that, given the scarcity of resources that people desire, economic analysis attempts to predict how best to allocate these resources. If these resources will be allocated best without legal intervention, then law and economics would suggest that no law be created. On the other hand, if law is needed to ensure proper resource allocation, law and economics would so indicate. Thus, according to Posner, law and economics has both positive and normative aspects.[9] On the positive side, economic analysis can be used to describe legal rules and results that form the foundation of common law. Normatively, economic analysis asserts that law makers and judges should opt for legal rules that advance efficient allocation of legal resources. The job of economics, then, is to examine the results of assuming that humans are rational maximizers and, hence, naturally pursuers of self-interest. Economic analysis suggests that in pursuing self-interest, individuals will necessarily advance the public interest. Thus, the goal of economics is efficiency, or in other words, the allocation of resources in such a way as to maximize value—where value is how much someone is willing to pay for something.[10]

For a number of reasons, economic analysis is an inappropriate means, by itself, for making decisions about the proper structure of law. Indeed, law is about social interaction. Thus, law is necessarily about justice, fairness, equality, and other aspects of social existence. Economic analysis often fails to capture all of these aspects of law. The primary reason for this failure of economic analysis is its attempt to make purely scientific that which cannot be explained by science alone. That is, law and economics as an approach to legal decision-making seeks to make law appear more, rather than less, scientific.[11] Thus, traditional law and economics avoids resort to humanities and other disciplines that provide alternative explanations of human interaction and social constructs. This is not to say that economic analysis is not useful for legal reasoning and decision-making. To the contrary,

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8. RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 3 (6th ed. 2003).

9. *Id.* at 3–16.

10. *Id.*

11. Robin Paul Malloy, *Framing the Market: Representations of Meaning and Value in Law, Markets, and Culture*, 51 BUFF. L. REV. 1, 17 (2003).

economic analysis has a definite role to play, but that role must accommodate for the many other aspects of human existence aside from those that are amenable to precise scientific understanding.

Specifically, one of the major failings of traditional economic analysis is the absence of accounting for decision-making that is not "rational" in an economic sense, but yet, is fully justifiable on other grounds. People are not always motivated to act by self-interest alone.[12] Indeed, people often act for purely non-selfish reasons—such as out of concern for the well-being of others, out of habit, in response to tradition, or out of regard for their subordination to the power of others. These various reasons for human action require reference to more than economics to be properly understood. Thus, to structure laws based primarily on the sole assumption of people as self-interested actors would not necessarily respond to real societal needs. Charities operate, not out of private self-interest, but instead out of a public benefit, or mission, interest. This is distinct from for-profit corporations, which operate so as to maximize economic profits. Therefore, attempts to articulate a rationale for the charitable tax exemption by resort to economic analysis alone necessarily miss this important distinguishing aspect of charitable operations.

In his "law and market economy" theory, Professor Robin Paul Malloy echoes a similar theme as that advanced by Nobel prize winning economist Amartya Sen in explaining that efficiency and wealth maximization are inadequate measures for assessing social well-being.[13] Malloy explains the market as a place of meaning and value formation in which real value emerges from the continuous process of exchange and interaction. He argues that the process of sustainable wealth formation is difficult to measure and understand in traditional efficiency terms. He demonstrates that the process of sustainable wealth formation relies on creativity, and on the dynamic nature

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12. This finding, that people are not always motivated by self-interest, is consistent with ideas espoused by scholars who advance the idea of behavioral law and economics as an evolved notion of traditional law and economics. *See, e.g.*, CASS R. SUNSTEIN, BEHAVIORAL LAW & ECONOMICS 8 (2000). Professor Sunstein explains:

> Economists sometimes assume that people are self-interested, in the sense that they are focused on their own welfare rather than that of others, and in the sense that material welfare is what most concerns them. This is sometimes true, and often it is a useful simplifying assumption. *But people also may want to be treated fairly and to act fairly, and, perhaps even more important, they want to be seen to act fairly, especially but not only among nonstrangers.* For purposes of understanding law, what is especially important is that people may sacrifice their economic self-interest in order to be, or to appear, fair.

Id. (emphasis added).

13. *See* MALLOY, *supra* note 5, at 50–52.

of inclusive, diverse, and extensive networks and patterns of exchange.[14] Value emerges from the dynamic interaction and play between people and their ideas. And, wealth formation is facilitated by connecting diverse individuals and communities so that valuable information fragments and experiences enter into the broader marketplace.[15] Discrimination, exclusion, and inaccessibility hinder the sustainability of the wealth formation process.

In this regard, Malloy challenges three fundamental aspects of traditional law and economics concerning the primary tension in law and economics, the primary means of wealth formation in the market, and the nature of market choice.[16] First, Malloy explains that the primary tension in LMT is between the concepts of efficiency and creativity, not between efficiency and social responsibility as alleged by traditional law and economics. He says that there is no need to understand the counterpart of social responsibility as efficiency because a properly functioning market incorporates an ethic of social responsibility. According to Malloy, efficiency, in law and economic terms, is grounded in the static notions of habit, convention, and continuity. Efficiency is reactive and is grounded in making the most of current understandings of the market. Creativity, on the other hand, is much more dynamic. According to Malloy, creativity is grounded in notions of potentiality, discontinuity, and indeterminacy. Thus, creativity is necessarily proactive and ever-evolving.[17]

Second, drawing on the tension between efficiency and creativity, Malloy argues that creativity in the market is the primary means of wealth formation, not efficiency. While efficiency is certainly relevant and has an important role to play in market theory, efficiency just cannot account for the process of creativity.[18] Efficiency requires ideal environments based on habit-informed

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14. *See* ROBIN PAUL MALLOY, LAW AND MARKET ECONOMY: REINTERPRETING THE VALUES OF LAW AND ECONOMICS 106–35 (2000).

15. *See id.* at 124.

16. *Id.* at 2–4. More specifically, law and economics alleges that the primary tension in the market is between efficiency and social responsibility; that efficiency is the primary means of wealth formation in the market; and that market choice is rational, objective, and the scientific result of cost and benefit analysis.

17. *Id.* at 3.

18. This aspect of Malloy's theory (highlighting the importance of creativity in the market) is reminiscent of the idea of "creative destruction" which was first introduced in 1942 by the Austrian Economist Joseph Schumpeter. "Creative destruction . . . describes the process of industrial transformation that accompanies radical innovation. In Schumpeter's vision of capitalism, innovative entry by entrepreneurs was the force that sustained long-term economic growth, even as it destroyed the value of established companies that enjoyed some degree of monopoly power." *See* Wikipedia, *Creative Destruction*, http://en.wikipedia.org/wiki/Creative_destruction (last visited Dec. 13, 2006).

conventions and pre-established relational choices. Creativity, on the other hand, relies on habit-deforming and transforming exchange relationships that permit the discovery of something new and different.[19] Creativity is by nature indeterminate, habit-breaking, and convention-challenging. Since it cannot be observed directly, creativity can only be examined by looking at the contextual communities which foster it. As Professor Malloy explains: "One must identify the types of communities which, by ethics and social values, tend to foster *diversity, experimentation, and unconventional networks* and patterns of exchange."[20] These are communities that embrace inclusion and diversity, and are ones that think about the market process in terms that are broader than economic efficiency.

Third, Malloy explains that market choice involves a process of interpretation—it is not a rational or objective fact which can be determined scientifically by cost and benefit analysis, unimpacted by social influences. Rather, market choice is the result of one's *interpretation* of market incentives and disincentives as informed by personal experiences rather than by abstract notions of objectivity and rationality.[21] A person's cultural biases, whether relating to race, sex, or sexual orientation, for example, have a decided impact on how he/she defines, interprets, and weighs the costs and benefits of a particular action. This distinction between *rational choice* and *interpretation* is a key aspect of Professor Malloy's divergence from traditional law and economics. As Professor Malloy explains:

> This distinction is important because the process of interpretation is community based, and because it indicates that even though exchange takes place as a continuous part of a dynamic system, our understanding of the exchange process is shaped by the interpretive "lens" or "screen" through which we view it. Furthermore, this lens or screen, as an indexical reference in semiotics, is grounded in a system of values informed by experience rather than by purely objective and rational choice.[22]

In essence, the reliance in law and economics on methodological individualism is flawed because it extracts the individual from the cultural-interpretive community in which she is embedded. At the same time it disconnects the individual from history and context, thus ignoring the

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19. MALLOY, *supra* note 14, at 78–90.
20. *Id.* at 3 (emphasis added).
21. *Id.* at 3–4.
22. *Id.* at 4.

interplay between an individual's experiences and her cultural-interpretive framework for understanding.[23]

B. Critical Race Theory

Instead of simply relying on economic principles to articulate a coherent rationale for the charitable tax exemption, traditional law and economic analysis should (and could)—as urged by LMT—be combined with other legal approaches to law in order to add an additional *screen* or *lens* through which to rationalize charitable tax exemption law. One example of a legal approach to law that might provide an additional lens, in addition to economic analysis, through which to filter and understand the charitable tax exemption is CRT.

CRT developed in the latter part of the twentieth century as a response by progressive scholars of color to critical legal studies, which in turn was a response to Legal Realism.[24] Legal Realists criticized the rule of law as overly formalistic and promoting, under the guise of neutrality and objectivity, a system of laws actually driven by policy, economics, and politics.[25] These revelations ultimately lead Realists to pronounce the law as indeterminate by nature. Critical legal scholars took the Realists' agenda a step further by deconstructing and delegitimizing the law—describing it as not only political, but also ideological and hegemonic.[26] As time passed, some scholars of color became disenchanted with critical legal studies because of its failure to acknowledge White supremacy and otherwise meaningfully critique racial power and racial hegemony.[27] These progressive scholars of color developed their own race-conscious approach to legal analysis, seeking to expose the legal and social construction of race itself with the goal of eradicating racial subordination.[28]

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23. *See id.* at 60–61. One way of understanding this interpretation issue is to think of the movie "Shallow Hal." *Shallow Hal* (Fox 2001). In the movie, the lead female character is a large overweight woman. However, one of the male characters who falls in love with her sees her as a thin and beautiful young woman. Despite the fact that everyone else sees the woman as overweight and unattractive, this male character does not see her that way at all—he *interprets* what he sees when he looks at her as a vision of loveliness.

24. Emily M.S. Houh, *Critical Interventions: Toward an Expansive Equality Approach to the Doctrine of Good Faith in Contract Law*, 88 CORNELL L. REV. 1025, 1051, 1054–58 (2003).

25. *Id.* at 1055.

26. *Id.* at 1055–56.

27. *Id.* at 1057.

28. *See id.* at 1057–58.

CRT is characterized primarily by its opposition to three mainstream beliefs about racism: 1) that color-blindness will eliminate racism; 2) that racism is an individual act, not a systemic problem; and 3) that problems of racism can be addressed without dealing with other forms of societal injustice such as sexism, homophobia, or economic exploitation.[29] One of the central concepts in CRT is that race is a social construct—an idea. In other words, the concept of race occurs, not naturally, but by invention in society. Understanding race as a social construct helps to explain both racial existence and racial hierarchy.[30] Another important concept in CRT is its rejection of racial essentialism. Essentialism refers to the assumption that a particular race has a certain essence. CRT rejects this essentialist approach to race. Instead, for CRT, race is contextual. As Kimberle Crenshaw has explained, CRT is committed to the idea that racial identities are intersectional and that racial minorities' vulnerability to discrimination is a function of specific intersectional identities.[31]

C. The Relatedness of Law and Market Economy and Critical Race Theory

Malloy's law and market economy theory shares many attributes with CRT on the subject of challenging traditional law and economic analysis.[32] Both law and market economy theory and CRT reject the primacy of efficiency as espoused in traditional economic analysis.[33] Professor Malloy's challenge to efficiency is from a market perspective, while critical race theorists challenge efficiency from an equality perspective.[34] Professor Malloy explains that creativity, not efficiency, is the primary means of wealth creation in the market. Similarly, critical legal scholars explain that racism is not just a problem of individual choice, but instead is the result of a systematic condition of racial subordination. Thus, both law and market economy theory and CRT reject the notion that the focus of proper legal structure should be on the calculus of individual choice. Instead, the focus should be on the diversity of societal structures that create the circumstances leading to the choice.

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29. Devon W. Carbado & Mitu Gulati, *The Law and Economics of Critical Race Theory*, 112 YALE L.J. 1757, 1766–67 (2003) (reviewing FRANCISCO VALDEZ ET AL., CROSSROADS, DIRECTIONS, AND A NEW CRITICAL RACE THEORY (2002)).

30. *See id.* at 1769–71.

31. *See id.* at 1774–75.

32. *See* Houh, *supra* note 24, at 1063–66.

33. *Id.* at 1063.

34. *Id.*

According to Malloy, market analysis is primarily concerned with the human practice of exchange—about who initiates exchange, who is excluded from exchange, what is subject to exchange, and on what terms exchange occurs.[35] Furthermore, he argues that it is important to examine the way in which people experience the market exchange process—noting "that experience varies by a number of characteristics [such as] race, gender, age, and education level, among others."[36] These contextual and experienced-based considerations of the market are consistent with similar considerations and values expressed in CRT.[37]

In addition to challenging traditional law and economics as focused too much on efficiency, law and market economy theory and CRT both acknowledge the overt political nature of market actors—affirmatively acknowledging the societal/contextual influences on law makers, judges, and those subject to law.[38] Traditional law and economics attempts to conceal many of these contextual influences by projecting an air of neutrality or objectivity through use of the science of economics. However, Professor Malloy unmasks this charade by explaining how law and economics scholars misunderstand both the impact of racial subordination on market exchange processes and the indeterminate nature of the market exchange process.[39] Despite the similarities between CRT and traditional law and economics theory with regard to both being politicized—one overtly so and the other not so overtly—many still view law and economics as more objective than CRT. Nevertheless, it is clear that CRT has a role to play in understanding law in a social context.

More specifically, because critical race theorists offer a view of social context that is just as legitimate as that offered by traditional law and economics, it seems perfectly reasonable to examine the charitable tax exemption through the *dual lenses* of CRT and traditional law and economic analysis. Though tax laws by nature appear readily amenable to economic analysis, this conclusion fails to take account of the uniqueness of tax laws concerning charities. Unlike many tax laws that deal with raising government revenue, tax laws imposed on charities do not have this overt revenue-raising goal. Instead, the overarching goal of tax laws imposed on charities is to enhance the mission of charities. In fact, it is only when a charity diverts from

35. *See* MALLOY, *supra* note 5, at 1–25; MALLOY, *supra* note 14, at 57–69.
36. *See* MALLOY, *supra* note 5, at 1.
37. See, for example, *id.* at 6, as an example of these connections.
38. *See* Houh, *supra* note 24, at 1063–66.
39. *See id.*

its mission that its tax exemption is jeopardized.[40] As one examines the complex nature of the charitable tax exemption, one must ask: "Why are charitable corporations not required to pay income taxes?" The exemption has traditionally been rationalized on efficiency grounds. However, efficiency cannot be used to rationalize all aspects of the charitable tax exemption. What about the other conceptions of justice and fairness that are not reflected in the calculus of economic efficiency? Thus, LMT offers an analytical approach to the charitable tax exemption that helps us to better rationalize it.

In support of this proposition—that LMT permits a better rationalization of the charitable tax exemption, the remaining parts of this article do four things. First, Part II proposes a new theory of the charitable tax exemption premised on LMT concepts. Second, Part III explains various aspects of the charitable tax exemption from the perspective of this new theory. Third, Part IV compares and contrasts this new theory with many of the pre-1990 theories of the charitable tax exemption that are based almost exclusively on principles of traditional economic efficiency. Finally, Part V briefly identifies some of the implications of this new theory on the structure of tax exempt charity law.

II. A DIVERSITY THEORY OF CHARITABLE TAX EXEMPTION

A. Diversity as a Value

Diversity has long been recognized as globally beneficial. In nature, for example, diversity is seen as a key component for plant and animal species survival. In financial investments, diversity is seen as the principal means of reducing risk of capital loss and ensuring sustainable growth over the long run. Importantly, in education, society values diversity as imperative if one is to have a quality and well-rounded educational experience.[41] This article

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40. *See, e.g.*, Branch Ministries v. Rossotti, 211 F.3d 137 (D.C. Cir. 2000) (litigation involving Branch Ministries' tax-exempt status instigated by Branch Ministries' ad in a national newspaper against Bill Clinton); Kelly Brewington, *NAACP Retains Tax Exemption Despite Bond's Speech, IRS Says*, BALT. SUN, Sept. 1, 2006, at A1 (discussing the IRS's challenge to NAACP's tax-exempt status because of its leader's speech against president Bush); Benjamin Weiser, *An Empire on Exemptions?: Televangelist Pat Robertson Gained Fortune, and Critics, In Sale of His Cable Network*, WASH. POST, Feb. 13, 1994, at H1 (discussing controversy over appropriateness of revoking CBN's tax-exempt status given its commercially successful broadcast network).

41. *See, e.g.*, Grutter v. Bollinger, 539 U.S. 306, 343 (2003) (upholding the University of Michigan Law School's affirmative action plan as consistent with the equal protection clause); Gratz v. Bollinger, 539 U.S. 244, 275 (2003) (invalidating the University of Michigan's undergraduate admissions policy as violative of the Equal Protection Clause).

asserts that diversity is also the driving force behind the charitable tax exemption. The diversity made possible by the charitable tax exemption breeds creativity, ingenuity, and other things that stimulate society and, in turn, market growth and development. The charitable tax exemption contributes to diversity by offering alternative means of accomplishing societal objectives in a market context. Thus, charities offer alternatives to for-profit corporations and to government.[42]

Charities are just one of the many types of corporate entities that operate in the United States. A key distinction between nonprofit charitable corporations and for-profit corporations is the lack of shareholders in the former. This means that while for-profit corporations are generally presumed to be profit-motivated institutions, nonprofit charities carry no such presumption. Instead, nonprofit charities are mission-driven and are legally prohibited by the nondistribution constraint from extracting profits from the corporation for private or personal gain.[43] Thus, nonprofit charities provide a viable *alternative* to the for-profit way of running a corporation—mission focused as opposed to profit focused. This alternative corporate structure—indeed, this *diversity* in corporate structure—in turn, contributes to the possibility and actuality of diversity in output. For example, this diversity in corporate structure means that we have for-profit corporations performing research concerning potentially very profitable drugs for treatment of HIV and AIDS, while nonprofit charitable corporations search for a far less profitable vaccine for this same disease.[44] Imposing a tax on income incidentally earned from these mission-driven activities would only serve to slow accomplishment of the mission.[45]

In addition to being an alternative to the corporate form of organization, charities also offer an alternative to government.[46] Like nonprofit charities,

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42. Professor Jill Horwitz has reached similar conclusions regarding the value to society of the alternative forms of hospitals, including for-profit, not-for-profit, and government hospitals. *See* Jill R. Horwitz, *Why We Need the Independent Sector: The Behavior, Law, and Ethics of Not-for-Profit Hospitals*, 50 UCLA L. REV. 1345 *passim* (2003).

43. *See infra* Part III.

44. *See Jerry Avorn Discusses This Year's Flu Vaccine Shortage, All Things Considered* (NPR radio broadcast Oct. 6, 2004) (describing nonprofit efforts to develop an AIDS vaccine as compared to for-profit efforts to seek potentially more financially profitable drugs for treatment of AIDS).

45. This is one way in which efficiency analysis as a normative principle works in conjunction with other conceptions of justice to help explain the charitable tax exemption. As more fully developed in Part IV, this article embraces the idea that an income tax on charity income would "cut retained earnings . . . and hence would further cripple a group of organizations already capital-constrained." Hansmann, *supra* note 3, at 74.

46. *See* Brody, *supra* note 3, at 586.

government does not have shareholders and is mission-driven. However, one key difference between government and all corporations—both for-profit and nonprofit—is government's ability to impose a tax (through law) as a means of financing the production of its goods and services. The government's ability to raise capital through taxation does not mean that government has an endless supply of money, nor does it mean that government can do whatever it wishes to do with this money. Indeed, a key limitation of government activity is the requirement to obtain political support. This means that, unless the public at large is willing to support the acquisition of particular goods or services with direct outlay of tax monies, those goods or services will not be acquired by government and, hence, will not be supplied to the public *by government*. Accordingly, to the extent that provision of a particular good or service has some support amongst citizens, yet lacks sufficient political support to garner government backing, it will be up to nonprofit charities to supply the good or service—financing that supply with either tax-exempt profits or tax deductible donations.

B. Diversity in Context

Diversity as a value, however, need not be thought of as an unprincipled process approach to law that is lacking in limits or principle. Diversity as a value should be considered in context. Here, "context" refers to that aspect of law that requires consideration of multiple points of interest—both public interests and private interests.[47] For example, diversity as a value does not mean that charities should be able to advance any conceivable private purpose.[48] Thus, tax-exempt charities, because of the public policy doctrine, cannot engage in invidious racial discrimination against black people. Simply recognizing that racial preferences promote diversity is not enough. LMT teaches us that law must also account for racial preferences in various contexts and from various perspectives—that is, law must contextually mediate public societal interests and private societal interests regarding racial preferences.[49] For instance, a critical race perspective of law would indicate that there is a qualitative and meaningful difference between socially beneficial race-based affirmative action (equalizing opportunities) and the societal harm advanced by racial discrimination (continued racial subordination). Thus, contextual

47. *See* MALLOY, *supra* note 14, at 115.
48. *See infra* Part III.C.
49. *See supra* Part I.B.

diversity would suggest that even though racial preference in the context of racial subordination is not permissible in tax-exempt charity law,[50] racial preference in the context of affirmative action may be permissible.[51]

"Context" also explains other aspects of charitable tax exemption law which limit private profit taking and private benefit,[52] lobbying and political campaigning,[53] competitive business functions,[54] and private endowments.[55] Granted, each of these limitations imposed on charities—including the public policy limitation—appears to impinge on what a charity may do and, thus, seems to hamper certain types of diversity. One must bear in mind, however, that the aim of the charitable tax exemption is to allow for activities that benefit public interests, not private ones. Thus, as explained in this article, the various limitations imposed on charitable activity are all aimed, in one way or another, at contending with the individual human tendency to seek out authoritative influence to advance private objectives.[56] In other words, the purpose of these limitations is to mediate between the private individual tendency for authoritative control and the public interests advanced by the charitable entity. Thus, the diversity value advocated in this article is not

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50. *See* Bob Jones Univ. v. United States, 461 U.S. 574 (1983).

51. *See* David A. Brennen, *The Power of the Treasury: Racial Discrimination, Public Policy, and "Charity" in Contemporary Society*, 33 U.C. DAVIS L. REV. 389, 396 (2000). Justice Stephen Breyer recently echoed this idea that the same factual situation of racial preference can be viewed in two different ways under the law. In Breyer's view, racial preference in the context of affirmative action is not only constitutional, but also consistent with basic democratic principles:

> TOTENBERG: On the question of affirmative action in college admissions, Breyer defends the practice as an effort to include all segments of a population in higher education or, as one opinion in the majority put it, "The court should read the 14th Amendment guarantee to equal protection of the law in light of its purpose, to take people who had once been slaves and make them full members of society." That view prevailed in the Supreme Court by a 5-to-4 vote, but the dissenters argued that the 14th Amendment was intended to create a color-blind society that would judge people on merit, not skin color.
>
> Justice BREYER: Both of those theories, as a matter of pure logic, are good. So in a situation where an interpretation is so close, I think it's useful to turn back to the basic function of the Constitution; that's where I think the democratic purpose had a role. Members of the armed forces, members of the business community, members of the university community said, "We need at least a limited degree of affirmative action in order to create a society where people will feel they belong to our institution."

Supreme Court Justice Stephen Breyer on "Active Liberty," All Things Considered (NPR radio broadcast Sept. 29, 2005).

52. *See infra* Part III.C.2.b.

53. *See infra* Part III.C.2.a.

54. *See infra* Part III.D.

55. *See infra* Part III.E.

56. Malloy, *supra* note 11, *passim*.

unbridled diversity; rather, it is "contextual diversity" in the sense that the scope of permissible charitable activity is not without limits.

In addition to understanding that diversity as a value is not unlimited in scope, one must also appreciate the fact that the theory espoused in this article is just that—a theory of the charitable tax exemption. Like all theories, it is not perfect and is not intended to necessarily reflect every aspect of the charitable tax exemption. Indeed, just as economic analysis admittedly does not explain all that bears on the marketplace, the contextual diversity theory outlined in this article does not profess to explain every aspect of the charitable tax exemption. However, what contextual diversity does do is explain many aspects of the charitable tax exemption that are not explained, nor are explainable, by traditional economic theories. Contextual diversity also complements, and in many cases extends, more modern theories of the charitable tax exemption, such as Rob Atkinson's altruism theory and Evelyn Brody's sovereignty theory. Thus, just as the altruism and the sovereignty theories were not intended to replace Bittker and Rahdert's base-defining theory or Hansmann's capital formation theory, neither is contextual diversity intended to replace altruism, sovereignty, or any economic theory of charitable tax exemption.

In the end, contextual diversity offers a normative rationalization of the charitable tax exemption that can assist—in conjunction with economic analysis—in better outlining the contours of charitable exemption law. Consider again the example of tax-exempt law's public policy doctrine and its limitation of charitable activity to activity that is not inconsistent with established public policy. Established public policy is often conceived of in application as federal governmental policy[57] or majoritarian compliance.[58] Contextual diversity would suggest that the adoption of the public policy doctrine was inappropriate in the sense that it was overkill. Indeed, "established public policy"—whatever it means—does not define the bounds of charity. Instead, LMT suggests that the scope of charitable activity is varied, diverse, dynamic, and transformative.[59] Charitable activity may be

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57. *See* Johnny Rex Buckles, *Reforming the Public Policy Doctrine*, 53 U. KAN. L. REV. 397 (2005).

58. *See* Bob Jones Univ. v. United States, 461 U.S. 574, 606–12 (1983) (Powell, J., concurring).

59. *See, e.g.*, Malloy, *supra* note 11, at 103.

> [P]eople positioned in alternative interpretive communities use different interpretive frames and references. Thus, different people understand the world in different and sometimes conflicting ways. Therefore, we must be aware of a variety of cultural-interpretive perspectives as they influence the direction of law and social policy. Consequently, we must understand the relationship between law, markets and culture, and we must realize that by shifting interpretive perspectives we

consistent with, have nothing to do with, or, most importantly, be completely contrary to "established public policy" as presently conceived.[60]

A Piercian semiotic interpretation of the legal idea (or, semiotically speaking, *sign*) "charitable" illustrates that its meaning has variance across cultural-interpretive communities. In this regard the designation of an activity as "charitable" can be understood as an interpretation of, and a representation of, particular underlying values.[61] In some contexts, for example, "charitable" stands as a representation for fulfilling a public purpose with respect to others who are truly in need, with no pejorative connotation. In other contexts the term "charitable" denotes action taken in support of subordinated people and functions as a sign of one's nobility in dealing with lesser or inferior beings. As a sign of public policy, "charitable" activities may take on multiple nuanced meanings and may function, depending upon the context, as an interpretation of underlying socio-legal values supporting invidious racial discrimination. We cannot determine the appropriate contextual meaning of "charitable" by reference only to positive economics and its emphasis on efficiency analysis. We need a more textured and nuanced approach to exchange relationships in a market context.

For example, understanding the problems of permissible and impermissible racial preferences must be informed by the contextual positioning of the parties involved. Markets are not fully objective and neutral avenues of exchange; they are the product of human practice and culturally informed values. Thus, when faced with the issue of the permissibility of invidious racial discrimination by tax-exempt charities, a careful consideration of the context of this type of racial preference reveals that mere racial preference was not the problem in *Bob Jones University v. United States*. The problem, as Critical Race Theory teaches us, was a problem of unjustified inequality—the continued racial subordination of blacks long after the end of legalized slavery. Accordingly, prohibiting racial subordination (the underlying problem), instead of prohibiting acts that are contrary to "established public policy," will better advance the goals of contextual diversity.[62]

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can alter authoritative influence over the interpretation process.

Id.

60. Similarly, Professor Houh concludes that, for contract law, "[c]ontractual good faith may mean one thing to a critical race scholar, another to a conventional law and economics scholar, and another to a law and market economy scholar." Houh, *supra* note 24, at 1051.

61. *See* MALLOY, *supra* note 5, at 6–16, 104–10 (explaining framing, referencing, and representing).

62. In recommending the abolition of the public policy limitation in favor of an explicit rule prohibiting invidious racial discrimination by tax-exempt charities, this article draws on the teachings of

With this understanding of the charitable tax exemption as a backdrop, the article now begins to show how "contextual diversity" implicitly permeates various aspects of the exemption.

III. THE CHARITABLE TAX EXEMPTION—MORE THAN JUST TAX RELIEF

The charitable tax exemption consists of many varied and complex components. This section of the article describes these components in order to demonstrate that the charitable tax exemption is more than just relief of a financial obligation to pay a federal tax on income. Indeed, many charities arguably do not have income[63] or, if they do, they seek tax-exempt status primarily for reasons that have nothing to do with the federal income tax exemption.[64] Thus, the purpose of this section is to show the important and vital role the charitable tax exemption plays in daily life from the standpoint of justice, fairness, equality, and other non-economic values. This section also articulates that, along with the general income tax exemption, tax-exempt charities receive many other benefits and must bear many burdens. In short, the charitable tax exemption is about much more than mere tax relief; it is about how private market actors benefit from having corporations that are profit-focused in addition to having corporations that are mission-focused.[65]

A. The Exemption

At its most basic level, the charitable income tax exemption that is the subject of this article is the statutory relief from the obligation of certain nonprofit corporations to pay tax on annual income.[66] This relief is granted pursuant to federal law and is given automatically to those corporations that

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Critical Race Theory regarding legal rules and principles that are "originally" prompted by racial discord but that avoid explicitly mentioning race in the formally adopted legal rule or doctrine. *See, e.g.*, Jerome McCristal Culp, Jr., *Toward a Black Legal Scholarship: Race and Original Understanding*, 1991 DUKE L.J. 39, 67-77 ("This liberal view of the Constitution and race, that race is better left unexplored, prevailed in much of the constitutional drafting.").

63. *See generally* Bittker & Rahdert, *supra* note 2, at 305, 307–14 (concluding that certain "nonprofit organizations . . . should be wholly exempted from income taxation, because they do not realize 'income' in the ordinary sense of that term").

64. *See* Brody, *supra* note 3, at 597–605 (discussing property tax motivations for charitable exemptions).

65. The essential implications of what it means to be mission-focused are outlined in the section on "proper purpose." *See infra* Part III.C.2.

66. *See* I.R.C. § 501(a).

apply for and are granted tax-exempt charitable status.[67] A variety of corporations other than charities are entitled to income tax exemption, including social welfare organizations,[68] labor organizations,[69] business leagues[70] and social clubs,[71] just to name a few.[72] However, charitable nonprofits, unlike practically all other tax-exempt nonprofits, are special in a variety of ways. For instance, with few exceptions, charities are the only tax-exempt nonprofits that are also eligible to receive charitable donations from the public that entitle the donor to federal income tax benefits.[73] Federal law provides that individuals and corporations that donate money or property to charitable corporations may be entitled to receive a tax savings when computing their own tax liability. The potential savings can be quite significant depending on the amount of the donation,[74] the type of property donated,[75] the income of the donor,[76] and the type of charity to which the donation is given.[77] This ability to receive tax deductible donations from the public is the key *federal tax law* distinction between charities and other tax-exempt nonprofits.[78]

In order to obtain tax-exempt charitable status, a desiring nonprofit corporation must file certain forms with the Internal Revenue Service ("IRS") seeking such status.[79] This is no small task. The forms are very complex and seek a voluminous amount of information concerning proposed organizational structure, proposed activities, financial assets, expected and past revenue streams, proposed policies, and much more.[80] Pursuant to federal law, the IRS

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67. *Id.* § 501(c)(3).

68. *Id.* § 501(c)(4).

69. *Id.* § 501(c)(5).

70. *Id.* § 501(c)(6).

71. *Id.* § 501(c)(7).

72. *See id.* § 501(c) (listing more than 20 different types of tax-exempt organizations).

73. *See id.* § 170(a). See § 170(c)(4) for exceptions for special funds in fraternal societies, etc.

74. *See id.* § 170(a).

75. *See id.* § 170(b)(1)(C) (imposing limits on deductibility of certain capital gain property).

76. *See id.* § 170(b)(1)(A), (B) (imposing limits based on an individual contributor's adjusted gross income).

77. *See id.* § 170(b)(1)(B), (D) (imposing limits based on whether the charity is a private foundation or not).

78. Although the charitable tax deduction for individuals who contribute to charities is a key aspect of charitable corporations, this article does not attempt to incorporate the deduction component into an overall rationalization of the exemption. Others who have attempted to draft a theory of tax exemption have similarly omitted discussion of the charitable tax deduction because of the "different issues" raised. *See* Hansmann, *supra* note 3, at 55–56.

79. Section 508(a) requires filing of IRS Form 1023.

80. IRS Form 1023 requires the applicant to disclose basic identification information. It also requires disclosure of information about the organizational structure, compensation of officers, members

must evaluate the information provided on these forms to determine if the applicant's proposed activities and organizational structure are consistent with activities and structures that are deemed "charitable." Importantly, if the IRS determines that the information provided on the organization's forms do not adequately comply with the law, then the IRS, subject to later judicial review, has sole discretion as to whether to grant or deny the applicant tax-exempt charitable status.[81] Further, even if it grants tax-exempt charitable status based on the applicant's organizational documents, the IRS can later revoke that status if the applicant does not operate in compliance with federal law.[82] Accordingly, even after its initial submission of forms seeking tax-exempt charitable status, a charity must often also submit annual information reports to the IRS concerning its on-going operations.[83]

These extensive requirements related to obtaining and maintaining tax-exempt charitable status provide one with just a glimpse of the many aspects of the charitable tax exemption that go far beyond merely being excluded from the requirement to pay federal income tax. Granted, all tax-exempt nonprofits—charitable or not—must file forms seeking tax-exempt status.[84] However, the forms required for tax-exempt charitable status are much more involved and much more complicated than those required of other tax-exempt nonprofits.[85] Perhaps the added complexity is due in part to the additional financial impact on tax revenues that accompanies granting tax exemption to an organization that will also be eligible to receive tax deductible donations from the public. But the added complexity could also be related to something else, something that has nothing to do with dollars. Perhaps the added complexity has something to do with the nature of charities in a market society. Indeed, the reason charities are eligible to receive tax deductible

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of the organization, activities, financial data, public charity status, and user fee information. There are also various schedules that will need to be filled out depending on the type of organization. *See* IRS Form 1023, *available at* http://www.irs.gov/pub/irs-pdf/f1023.pdf.

81. Section 7805(a) delegates to the Treasury Department, who further delegates to the IRS, the power to prescribe all needful rules and regulations concerning the enforcement of the Internal Revenue Code.

82. *See* Treas. Reg. § 1.501(c)(3)-1(c) (as amending in 1990) (describing the operational requirement).

83. Section 6033 requires all exempt organizations to file an annual informational return (either IRS Form 990 or 990T).

84. *See* IRS Form 1024, *available at* http://www.irs.gov/pub/irs-pdf/f1024.pdf (required for non-charities).

85. One example of the added complexity of Form 1023 as compared to Form 1024 is that Form 1023 asks more specific and detailed questions about the organization's activities. On the other hand, Form 1024 allows the organization to write a narrative of its activities with only a few minimum requirements.

contributions is that they are required to use these monies for charitable purposes, as opposed to mutual benefit purposes as is the case with other tax-exempt nonprofits. Thus, when the IRS grants an organization tax-exempt charitable status, it is not only excusing the organization from the requirement to pay federal income tax; it is also signaling to potential donors that the organization has given every indication that the donation will be used for charitable purposes and that the public can trust in this assurance.

B. Benefits of the Exemption

In addition to being excused from the requirement to pay tax on annual income, the charitable tax exemption opens doors to a variety of other economic and non-economic benefits. Among the economic benefits to a nonprofit corporation with tax-exempt charitable status are relief from the requirement to pay federal unemployment taxes,[86] access to tax-exempt government bonds,[87] and eligibility for preferred postal rates.[88] In addition to these direct economic benefits, tax-exempt charities are also eligible for many indirect economic benefits granted by state and local governments. Some of these state and local economic benefits include exemption from state and local income taxes,[89] state and local sales taxes,[90] and local real property taxes.[91] Thus, to the extent that a nonprofit corporation has economic motivations for seeking tax-exempt charitable status, those motivations may relate to the federal income tax exemption or, possibly, to one or more of the many other economic benefits.

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86. I.R.C. § 3306(c)(8). Under the present system, charities only have to pay the "equivalent of the former employees' unemployment compensation." Bazil Facchina et al., *Privileges & Exemptions Enjoyed by Nonprofit Organizations*, 28 U.S.F. L. REV. 85, 101–02 (1993).

87. Ninety five percent of the net proceeds from these tax-exempt bonds must be used by the charity and all property purchased with the bond proceeds has to be owned exclusively by the charity. I.R.C. § 145(a)(1) (allowing state and local governments to issue bonds paying interest, exempt from federal income tax, to organizations described in § 501(c)(3)).

88. The current postal regulations give religious, educational, scientific, philanthropic, agricultural, labor, veterans', and fraternal organizations second and third class nonprofit rates. Facchina et al., *supra* note 86, at 112. The only requirement is that the nonprofit mailers must be organized and operated for the primary purpose of the organization. *Id.* at 113.

89. For example, Pennsylvania provides an exemption to charities from state and local income taxes. 72 PA. CONS. STAT. ANN. § 7204(10) (West 2005).

90. Illinois automatically exempts § 501(c)(3) organizations from its sale/use tax. 35 ILL. COMP. STAT. § 105/3-5 (West 2005).

91. California provides a property tax exemption to nonprofits. CAL. REV. & TAX. CODE § 214.15 (West 2005).

Importantly, there are many non-economic benefits that accompany tax-exempt charitable status that might be more "valuable" than the various economic benefits. For example, the "halo effect" that accompanies charitable status may have no economic value at all. The "halo effect" is that indeterminable aspect of charitable status that results in positive emotional effects. These positive effects may exhibit themselves in many ways. Examples include when one gives money to a church without concern for receiving a charitable tax deduction, when one serves on a charitable board without expectation of financial payment for services, or when the public just generally has a positive view of an institution due solely to the fact that it is mission-driven as opposed to profit-driven. Even though the halo effect produces real "value"—both for the corporation and for the public at large, that value is not often calculable in economic terms.

In addition to the halo effect, the charitable tax exemption allows for diversity and experimentation that often lead to production of undiscovered values.[92] While these values may eventually be calculable, they are at first indeterminable and unknown. Finally, some aspects of the charitable activity are not reducible to dollars and cents and are, therefore, not capable of the types of comparison required for economic analysis. For example, economic values do not fully reflect the value of an education in a multi-racial environment as compared to a racially segregated environment. These ethical, emotional, moral, and indeterminate values of charities are not something that can be fully explained in terms of economic efficiency, often because the value is shared by the charity and by those not associated with the charity.[93] Thus, these non-economic values cannot be easily, or sometimes not at all, translated into economic terminology.[94]

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92. One of the non-economic benefits that accompany tax-exempt charitable status is the production of undiscovered values. Tax-exempt charitable status often provides an incentive for exploration of unpopular or unprofitable ventures. For example, the Center for the Expansion of Fundamental Rights is a tax-exempt organization whose primary purpose is to obtain "fundamental legal rights—such as bodily integrity and bodily liberty for nonhuman animals." Symposium, *Ten Years of Animal Law at Lewis & Clark Law School, Remarks: The Evolving Legal Status of Chimpanzees*, 9 ANIMAL L. 1, 25 (2003). Such an organization would not be able to exist without charitable tax exemption because there is no market interest in such a cause. Because of the tax benefits associated with charitable status, the organization can continue its primary purpose of obtaining fundamental legal rights for nonhuman animals. The benefits of improved bio-diversity can lead to scientific innovations, such as a cure for cancer, which are currently unknown or indeterminable in economic terms.

93. One of the principle aspects of LMT, discussed *supra* Part I, is that many apparent two-party exchanges or relationships often involve others who are not directly involved in the market exchange.

94. It is precisely because charities seek to promote values that are difficult to measure using economic terms that the nonprofit legal framework has been noted as raising "important cultural interpretive

C. *Obligations that Flow from the Exemption*

Aside from the many benefits that accompany tax-exempt charitable status, there are many obligations that a charitable corporation must abide by in order to obtain and maintain such status. Some of these obligations were previously alluded to in connection with the discussion of the requirement to file forms seeking charitable status and the requirement to annually report information concerning activities and operations.[95] Statutorily, in order to obtain a charitable income tax exemption, a corporation must be:

> organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition . . ., or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation . . ., and which does not participate in, or intervene in . . ., any political campaign on behalf of (or in opposition to) any candidate for public office.[96]

This statutory requirement has been described as imposing several affirmative and negative obligations on tax-exempt charities.

1. *Affirmative Obligations*

a. *"Organized" and "operated"*

Affirmatively, tax-exempt charities must show that they are both "organized" and "operated" exclusively for a proper (or charitable) purpose. The "organized" requirement is met, quite straightforwardly, when the nonprofit applicant's organizing documents[97] and its federal forms used to apply for tax-exempt charitable status[98] are in compliance with the law.[99] Most notably, the organizing documents must clearly indicate that all assets of the proposed charity, upon dissolution, will go to other tax-exempt

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issues." *See* MALLOY, *supra* note 5, at 214.

95. *See infra* Part III.A.

96. I.R.C. § 501(c)(3).

97. For example, by-laws and articles of incorporation.

98. *E.g.*, IRS Form 1023.

99. Treas. Reg. § 1.501(c)(3)-1(b)(1) (as amended in 1990).

charities.[100] Further, the organizational documents must state that all assets will be used in compliance with statutory requirements applicable to tax-exempt charities, namely for charitable purposes and not for inappropriate political, lobbying, or private purposes.[101] In other words, the organizing documents must affirmatively demonstrate that all charitable assets will remain in the charitable stream and that no profits will be inappropriately paid to private or political interests. The "operated" requirement is essentially the same as the organizational requirement, except that the operated requirement is concerned with whether the actual activities performed by the tax-exempt charity are consistent with the statutory requirements.[102] Thus, not only must the nonprofit applicant say that it will be charitable, it must also demonstrate its charitableness by its actions.

b. Proper (or charitable) purpose

The proper purpose requirement is at the heart of the charitable tax exemption. This requirement imposes an obligation on the charity to have a special type of mission focus as opposed to a profit focus. The mission is not just any mission and is distinctly different from the mutual benefit mission of non-charitable nonprofit corporations.[103] Instead, the mission that constitutes a proper purpose for the charitable tax exemption must be what is collectively referred to as a *charitable* purpose. For simplicity, this article uses the term "charitable" in a broad sense, referring to any variety of public purposes that might be acceptable under the statute.[104] Some of these purposes are specifically delineated in the statute—religious and educational, for example. However, many charitable purposes have to be gleaned, by either the IRS or reviewing courts, from the statute. Some purposes that have been recognized as "charitable" include providing relief to the poor,[105] protecting the environment,[106] combating community deterioration,[107] providing homes for

100. *Id.* § 1.501(c)(3)-1(b)(4).

101. *Id.* § 1.501(c)(3)-1(b)(3).

102. *Id.* § 1.501(c)(3)-1(c)(1).

103. A "mutual benefit" mission is one that is focused on primarily benefiting a particular group of persons who are oftentimes members. For example, a nonprofit social club or fraternity is a mutual benefit organization. *See* Hansmann, *supra* note 3, at 93–96.

104. I.R.C. § 501(c)(3).

105. Treas. Reg. § 1.501(c)(3)-1(d)(2) (as amended in 1990).

106. *Id.*; Rev. Rul. 76-204, 1976-1 C.B. 152.

107. Treas. Reg. § 1.501(c)(3)-1(d)(2) (as amended in 1990); Rev. Rul. 70-585, 1970-2 C.B. 115.

the elderly,[108] improving health,[109] and many more.[110] All of these specifically recognized charitable purposes have at least one thing in common—they all seem to impart some "valued" benefit upon the public and not just a defined mutual benefit (or membership) group.

A key question for the charitable tax exemption is how to determine whether a particular purpose is "charitable" or not.[111] True, a purpose that is arguably a subset of already recognized charitable purposes does not present many conceptual difficulties. For instance, if an organization has as its mission the protection of swamp land, that organization's purpose is probably charitable because it involves protection of the environment in its natural state—a well-established charitable purpose.[112] But there are at least three distinct ways in which determining whether a particular purpose is charitable or not charitable becomes conceptually more complicated. The first instance is when a newly proposed purpose does not appear to fit within a subset of an already recognized charitable purpose. That is, what if, in order to conclude that a particular purpose is charitable, one would necessarily have to add another item to the list of potential charitable purposes. For example, would it have been "charitable" for Frederick Douglass to advocate that slavery was morally wrong during a time when slavery was completely legal and thought by many to be morally acceptable? Was it "charitable" for Nicolaus Copernicus to advocate that the sun, and not the earth, was the center of our universe at a time in history when all believed that the earth indeed was the center of the universe? The underlying conceptual quandary is not how these questions would be answered in hindsight, but rather, how they should be answered when they arise.

The second instance in which defining the term "charitable" becomes conceptually difficult is when the nature of a previously recognized charitable purpose has changed such that it no longer seems to be charitable. This conceptual difficulty is most prevalent today in the field of healthcare and the exemption of hospitals as "charitable" nonprofit corporations.[113] Historically,

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108. Treas. Reg. § 1.501(c)(3)-1(d)(2) (as amended in 1990); Rev. Rul. 72-124, 1972-1 C.B. 145.

109. Treas. Reg. § 1.501(c)(3)-1(d)(2) (as amended in 1990); Rev. Rul. 77-69, 1977-1 C.B. 143.

110. *See generally* DARRYL K. JONES ET AL., THE TAX LAW OF CHARITIES AND OTHER EXEMPT ORGANIZATIONS 129–65 (2003) (discussing standards of tax exemption for hospitals, health maintenance organizations, emergency rooms, and public interest law firms).

111. *See* Hansmann, *supra* note 3, at 57–58 ("[T]he repeated and unreflective reinterpretation of the exemption to accommodate new forms of nonprofit [charitable] activity . . . offers clear evidence of the lack of, and need for, a coherent policy on which to base the exemption.").

112. Rev. Rul. 80-278, 1980-2 C.B. 175.

113. *See* Hansmann, *supra* note 3, at 65–67 (arguing that many hospitals and other commercial

hospitals were granted charitable tax-exempt status because they provided health care to the poor, an established charitable purpose.[114] Over time, however, this view of the basis for exempting hospitals changed such that hospitals no longer are required to provide health care to the poor.[115] Thus, we have a healthcare market in the United States in which for-profit hospitals operate alongside charitable nonprofit hospitals.[116] Does this state of affairs indicate that hospitals should no longer be tax-exempt because efficiency analysis suggests that hospitals would exist with or without the exemption?[117] If so, is there some value aside from efficiency which would indicate that, despite the economics, we still need tax-exempt hospitals? Pursuant to contextual diversity, if the economic analysis suggests that hospitals should no longer be tax-exempt, an additional question to ask is whether there are values besides economic efficiency which would suggest continuing to exempt hospitals.

The third instance in which defining the term "charitable" becomes conceptually difficult is when a proposed purpose violates the public policy

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nonprofits should not be tax-exempt as charities).

114. Rev. Rul. 56-185, 1956-1 C.B. 202, *modified by*, Rev. Rul. 69-545, 1969-2 C.B. 117, 203 (stating that a hospital must operate to the extent of "its financial ability for those not able to pay for the services rendered" in order to sustain exemption under § 501(c)(3)).

115. Rev. Rul. 83-157, 1983-2 C.B. 94 (hospital does not have to operate emergency room open to the poor to sustain § 501(c)(3) tax exemption if health planning agency has found that this would unnecessarily "duplicate emergency services and facilities that are adequately provided by another medical institution in the community").

116. The same dual tract phenomenon exists in other areas as well, such as homes for the aged. *See, e.g.*, Rev. Rul. 61-72, 1961-1 C.B. 188 (stating that a home for the aged is exempt if it is dedicated to providing, among other things, care and housing to aged individuals who would otherwise be unable to provide for themselves without hardship); Rev. Rul. 72-124, 1972-1 C.B. 145 (concluding that, as an alternative to Revenue Ruling 61-72, "an organization . . . which devotes its resources to the operation of a home for the aged will qualify for charitable status . . . if it operates in a manner designed to satisfy the three primary needs of aged persons. These are the need for housing, the need for health care, and the need for financial security.").

117. *See generally* Hansmann, *supra* note 3, at 89. Professor Hansmann explains:

> On the other hand, it is not at all clear that there is justification for the . . . decision to exempt nonprofit hospitals from taxation even if they provide no research, teaching, or subsidized care for indigents; that is, even if they are operated as strictly commercial nonprofits. Problems of contract failure do not seem important in the case of most hospital services. The continued predominance of the nonprofit form in this industry seems, instead, to be attributable to historical and financial factors largely unrelated to the relative efficiency of for-profit and nonprofit institutions.

Id.

A related question might be: Does this state of affairs indicate that we should adopt a law which prohibits the operation of for-profit hospitals, leaving the entire market to the nonprofit sector? Although this question is just as important for economic analysis purposes, it is not as critical here because it does not directly bear on the issue of whether hospital operation is "charitable" and entitled to tax-exempt status.

doctrine, a doctrine adopted by the Court and now incorporated into tax-exempt charity law. Pursuant to the public policy doctrine an organization that is otherwise "charitable" will not be eligible for charitable tax exemption if it engages in acts that contravene "clear" or "established" public policy.[118] The prototypical example of an instance in which the public policy doctrine would defeat charitable status is racial discrimination against blacks. For example, the Supreme Court affirmed the IRS' revocation of charitable status for a nonprofit religious school that discriminated against blacks in its admission policies.[119]

The public policy doctrine, as applied to racial discrimination against blacks, is not problematic in the sense that it is nearly universally accepted that discrimination against a person because she is black is morally repugnant. However, the public policy doctrine becomes difficult to apply in instances other than invidious racial discrimination against blacks. For example, should the public policy doctrine be applied in such a way as to deny charitable status to nonprofit schools that make racial preferences in the context of affirmative action?[120] While efficiency analysis might suggest that all racial preferences are prohibited by the public policy doctrine, how does this analysis accommodate the teachings of Critical Race Theory, which teaches that race based affirmative action is meaningfully different from invidious racial discrimination?[121] Thus, the conceptual difficulty with the public policy doctrine is how does one determine the existence of "clear" or "established" public policies other than the policy against invidious racial discrimination?

Addressing these three instances of conceptual difficulty concerning the meaning of the term "charitable"—new purposes, old purposes, and anti-public policy purposes—must lay at the heart of any theory of charitable tax exemption. If the charitable tax exemption has any normative coherence, it would seem that the coherence must somehow address these purposes, since they collectively represent the areas in which the parameters of the exemption are most often tested. Such is the implicit assumption of all existing theories of charitable tax exemption.[122] While many of the existing theories of charitable tax exemption rationalize portions of these conceptually difficult

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118. *See* Bob Jones Univ. v. United States, 461 U.S. 574, 591 (1983) ("A corollary to the public benefit principle is the requirement, long recognized in the law of trusts, that the purpose of a charitable trust may not be illegal or violate established public policy.").

119. *Id.* at 612.

120. *See* David A. Brennen, *Race-Conscious Affirmative Action by Tax-Exempt 501(c)(3) Corporations After* Grutter *and* Gratz, 77 ST. JOHN'S L. REV. 711, 725–30 (2003).

121. *See* discussion of critical race theory *supra* Part I.B.

122. *See* discussion of various theories *infra* Part IV.

aspects of defining "charitable," many do not.[123] In many cases, the lack of rationalization might be due to the absence of concern for that which cannot be rationalized by efficiency analysis. But that is the point—efficiency analysis cannot rationalize or explain all that exists in law. And while some theories of the charitable tax exemption have gone beyond efficiency and have resorted to non-economic analysis to explain the charitable tax exemption, even these theories—arguably—do not go far enough.

Like the existing theories of charitable tax exemption, the contextual diversity theory espoused in this article presumes that understanding the scope of the term "charitable" is key to understanding the normative rationale for the exemption. It is not enough to say that "charitable" simply means that which benefits the public. Where does that get us? How *should* we determine whether any particular activity benefits the public? Importantly, how should we determine whether a particular activity, that could benefit the public if done in a particular way, fails to do so because it contravenes "established public policy?" LMT, as explained earlier in this article, suggests that we may not be able to define the outer limits of charity (public benefit) due to the dynamic, ever-changing, and transformative nature of the marketplace.[124] Thus, the best we can hope for is to continually re-evaluate, from a variety of perspectives, what actually provides a benefit to the public. While many of these perspectives might involve economic analysis, many will not. Instead, "public benefit" may at times be determined based upon humanistic or other non-economic conceptions of justice, fairness, equality, or other important values.

2. Negative Obligations

In addition to the many affirmative obligations that flow from tax-exempt charitable status, many negative obligations also exist. Among the negative obligations are limits on political campaigning, legislative lobbying, private inurement, and private benefit.

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123. *See* Bittker & Rahdert, *supra* note 2, at 330–33.

124. Professor Malloy explains:

> Law and market economy theory involves the study of the social/market exchange process by focusing on the relationship between law, culture, and markets. This relationship is triadic, dynamic and multi-directional. Moreover, in this relationship, one can understand the market sphere as expressing a concern for individualization, with a market focus on the pursuit of self-interest. On the other hand, culture is a collective concept, and therefore the cultural sphere can be understood as expressing a community perspective or a notion of the public interest.

Malloy, *supra* note 11, at 63–64.

a. Politics and lobbying

The political campaign prohibition provides that tax-exempt charities cannot "participate in, or intervene in . . ., any political campaign on behalf of (or in opposition to) any candidate for public office."[125] Textually, this is an absolute prohibition in the sense that any amount of prohibited political campaign activity by a tax-exempt charity will result in the charity's loss of tax-exempt status. However, the IRS has indicated that even political-looking activities that may otherwise be covered by the political campaign prohibition will not cause loss of exemption if the activities do not show a bias for (or against) a candidate.[126] Additionally, the political campaign prohibition does not foreclose many activities often associated with political campaigns, such as voter education and "get out the vote" campaigns. Thus, the primary aim of the political campaign prohibition for charities is to prevent the usurpation of a charity for private, as opposed to public, political purposes.

The legislative lobbying limitation provides that "no substantial part of the activities" of a charity can consist of "carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h))."[127] This lobbying limitation effectively means that a charity cannot lobby elected officials so as to affect legislation in a particular (biased) way. Unlike the political campaign prohibition, the lobbying limitation is not a complete ban on legislative lobbying. Instead, the lobbying limitation only prohibits charities from engaging in more than an insubstantial amount of lobbying. Additionally, the lobbying limitation does not prohibit certain types of activities that clearly benefit the public, such as speaking at a legislative hearing concerning legislation pursuant to an invitation of the legislative officials.[128] Thus, much like the political campaign prohibition, the apparent aim of the lobbying limitation is to limit lobbying where it presumably fails to provide a public (as opposed to private) benefit.

Together, the political campaign prohibition and the legislative lobbying limitation serve to limit a charity's involvement in government matters to the extent that little public benefit is likely to result. Arguably, these limitations on governmental influence might be required even without the textual expression of them in the statute, at least to the extent that the campaigning or

125. I.R.C. § 501(c)(3).
126. *See* JONES ET AL., *supra* note 110, at 472.
127. I.R.C. § 501(c)(3).
128. Treas. Reg. § 56.4911-2(b)(3) (1990).

lobbying either violates one of the other negative requirements for exemption[129] or causes a violation of the "exclusivity" requirement.[130] However, having the textual expression of these limitations in the statute gives force to their anti-public aspects. While the campaign prohibition and the lobbying limitation may indeed have economic rationales, they could just as well have non-economic political rationales. For example, it could be that these government involvement limitations are a reflection of the sovereignty view of the charitable tax exemption—that is, the view that charities are a type of sovereign akin to state and local government entities.[131] Accordingly, any theory which attempts a normative explanation for the charitable tax exemption must also address this government involvement limitation.

b. Private inurement/benefit

Like the other negative obligations, the private inurement prohibition and the private benefit limitation have statutory origins. The private inurement prohibition provides that "no part of the net earnings" of a tax-exempt charity can "inure[ ] to the benefit of any private shareholder or individual."[132] This prohibition has been a part of tax-exempt charity law in the United States since the first corporate tax exemption in 1909 and, in fact, was the only negative obligation for charities at that time.[133] That original private inurement prohibition expressly prohibited distribution of the charity's financial surplus to the charity's controllers. Thus, the focus, at that time, was on preventing managers and others who controlled a charity from improperly taking profits from the charity.

The law regarding private inurement is structured in much the same way today in that the private inurement prohibition prevents certain "insiders" from taking charity profits other than as fair compensation for benefits conferred upon the charitable corporation. The prohibition is absolute in the sense that even if a "scintilla" of charitable profits go to insiders, the charitable exemption is lost.[134] The term "insiders" is not defined in the

129. *See* discussion of private benefit or private inurement prohibition *infra* Part III.C.2.b.

130. *See* JONES ET AL., *supra* note 110, at 446.

131. Brody, *supra* note 3, at 589.

132. I.R.C. § 501(c)(3).

133. *See* JONES ET AL., *supra* note 110, at 306; *see also* Corporation Excise Tax of 1909, ch. 6, § 38, 36 Stat. 113. In the first corporate tax exemption law, the only expressly stated requirement was that any financial surplus derived from conducting the charitable endeavor could not be distributed to those who control the entity by which charity is delivered. *See* JONES ET AL., *supra* note 110, at 306.

134. Darryll K. Jones, *The Scintilla of Individual Profit: In Search of Private Inurement and Excess*

statute except to state that charitable profits cannot go to any "private shareholder or individual." The IRS and the courts have developed divergent interpretations of precisely who might be considered an insider. Under the IRS' expansive view of the term, "insiders" are persons having a personal or private interest in the activities of the charity.[135] Thus, insiders could include those who have actual control of the corporation (such as board members and managers) and those who have virtual or constructive control of the charity (such as employees, and even independent contractors). The courts, on the other hand, take a less expansive view of the phrase "insiders," often limiting the phrase to board members and creators of the charity.[136]

The private inurement prohibition clearly illustrates an important aspect of this article's thesis that economic analysis alone cannot fully explain the charitable tax exemption. Economic analysis only tells us that diversion of corporate profits from a charity to private interests (insiders) is prohibited. What economic analysis does not necessarily tell us is how to determine who an "insider" might be. Should one take an expansive view of the term "insider," which would severely limit certain aspects of permissible charity operations? Or should one take a narrow view, which may open up possibilities for charity operations that might not otherwise exist? Whichever view one takes, economic analysis alone does not necessarily drive the entire decision. For instance, if one has a perspective of law which views government involvement in private affairs as undesirable, such as the view taken by many conservatives, one might choose a narrow view of the term "insider." On the other hand, if one has a perspective of law which welcomes government supervision of charities—a liberal view—one might choose the more expansive view of the term "insider." Thus, one's political perspective of law—either conservative or liberal, for example—might determine which view of the term "insider" is more *valuable* without regard to efficiency.

Although the private benefit limitation is also statutorily based, it is not as explicitly spelled out in the statute as is the private inurement prohibition. Instead, the private benefit prohibition resulted from interpretation of the term "exclusively" as used in the charitable exemption statute.[137] The IRS and

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Benefit, 19 VA. TAX REV. 575, 591 (2000). The legislative history for the first corporate tax exemption law provides that certain entities provide no person with a "scintilla of individual profit" from the entity. 44 CONG. REC. 4150–51 (1909) (statement of Sen. Bacon).

135. Treas. Reg. § 1.501(a)-1(c) (as amended in 1982).

136. United Cancer Council, Inc. v. Comm'r, 165 F.3d 1173, 1176–77 (7th Cir. 1999).

137. "Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes . . . ." I.R.C. § 501(c)(3).

various courts have determined that the term "exclusively" really means "primarily."[138] Thus, a tax-exempt charity will be considered exclusively charitable so long as it is primarily charitable. This means that a tax-exempt charity can perform a small amount of private benefit in addition to its primarily public benefit functions.[139] In addition to not being an absolute prohibition, another difference between the private inurement prohibition and the private benefit limitation is that the private benefit limitation is not focused solely on "insiders." According to the IRS, if a charity provides more than an insubstantial amount of private benefit to anyone—insider or not—it will no longer be considered "exclusively" charitable. Thus, despite the differences in terms of substantiality and prohibited beneficiaries, the private benefit limitation works in conjunction with the private inurement prohibition to ensure that charitable assets remain in the charitable (public) stream.

As with the other aspects of the charitable tax exemption, a theory of the exemption should attempt to account for the private benefit and private inurement aspects of the exemption. Indeed, every theory espoused thus far has not only accounted for the private benefit and private inurement obligations; these obligations play a central role in every economic rationale for the charitable tax exemption.[140] This is as it should be. For without the

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138. Treas. Reg. § 1.501(c)(3)-1(c)(1) (as amended in 1990); Am. Campaign Acad. v. Comm'r, 92 T.C. 1053, 1065 (1989).

139. One area in which this aspect of the private benefit limitation has caused controversy is when a charity joins with a for-profit entity to form a partnership. *See, e.g.*, St. David's Health Care Sys. v. United States, 349 F.3d 232 (5th Cir. 2003); Redlands Surgical Servs. v. Comm'r, 113 T.C. 47 (1999). The government and taxpayers disagree as to how the private benefit limitation should be interpreted in this context. For instance, the predominant government view is that the creation of the partnership causes loss of charitable status if the charity does not have *control* of the partnership. *St. David's Healthcare Sys.*, 349 F.3d at 239; Rev. Rul. 98-15, 1998-1 C.B. 718. Charities, on the other hand, argue that the issue is not control, but rather whether the partnership actually *functions* as an exclusively charitable entity. In at least one jurisdiction (the 5th Circuit), the court has determined that control is the appropriate standard:

> However, we cannot agree with St. David's suggestion that the central issue in this case is whether the partnership provides some (or even an extensive amount of) charitable services. It is important to keep in mind that § 501(c)(3) confers tax-exempt status only on those organizations that operate exclusively in furtherance of exempt purposes. As a result, in determining whether an organization satisfies the operational test, we do not simply consider whether the organization's activities further its charitable purposes. *We must also ensure that those activities do not substantially further other (non-charitable) purposes.* If more than an "insubstantial" amount of the partnership's activities further non-charitable interests, then St. David's can no longer be deemed to operate exclusively for charitable purposes.

St. David's Healthcare Sys., 349 F.3d at 236–37 (emphasis added) (citations omitted).

140. *See, e.g.*, Hansmann, *supra* note 3, at 72. Professor Hansmann articulates the crux of his efficiency-based capital subsidy theory of tax exemption as relying on the non-distribution constraint, which is the principle that a nonprofit organization is prohibited from distributing its net earnings to insiders:

requirement that private benefit and inurement be minimized, it is difficult to comprehend any coherent explanation for the charitable tax exemption. Thus, to this extent, economic analysis does have true value as an analytic tool.

LMT teaches us that some aspects of law can and should be explained by economics.[141] However, this does not mean that all, or even most, aspects of law can or should be so explained. Many aspects of law, including many aspects of tax-exempt charity law, have rationales that are not amenable to traditional neoclassical economic understanding or analysis. One cannot necessarily place an economic value on notions of justice, fairness, and equality that are not based on economic efficiency. Therefore, the key to understanding the charitable tax exemption is recognizing that any theoretical rationalization of the exemption must be broad-based and not rely *only* on notions of positive economic efficiency. In order to better understand this idea, Part I of this article explains how economic theories can be used effectively with non-economic theories to both explain and sculpt law. LMT articulates this idea and Professor Emily Houh has demonstrated its application in understanding the good faith exception in contract law.[142] Now, a few words about commercial competition of charities with for-profit corporations and private foundation charities.

D. Commercial Competition

Even though they are mission-focused and not profit-focused, charities often engage in commercial profit-making activities with the aim of furthering a distinct charitable purpose. One common by-product of this manner of operation is that charities sometimes compete with for-profit firms for market dollars. This competition—actual or constructive—might result from either of two possible circumstances. The first is when the charity engages in a commercial activity for the sole purpose of raising money to advance its

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There is an efficiency rationale for the exemption that is more appealing than those discussed above, although it seems never to have been expressly offered before. That rationale is that the exemption serves to compensate for difficulties that nonprofits have in raising capital, and that such a capital subsidy can promote efficiency when employed in those industries in which nonprofit firms serve consumers better than their for profit counterparts. Nonprofit organizations lack access to equity capital since, by virtue of the nondistribution constraint, they cannot issue ownership shares that give their holders a simultaneous right to participate in both net earnings and control.

Id.

141. Malloy, *supra* note 11, at 56–64.

142. *See* Houh, *supra* note 24, at 1038–54.

charitable mission.[143] A second circumstance of competition is when the charity engages in a commercial activity in such a way that the activity itself (as opposed to the revenues generated by the activity) furthers or constitutes its charitable purpose.[144] In an effort to make the charitable tax exemption more effectively focused on income generated by charitable *activity*, two developments in the law occurred. The first development was the repeal of the destination of income test for charitable exemption—thus making charitable activity itself more important than how profits are used.[145] The result was to prohibit charities from engaging in more than an insignificant amount of non-charitable commercial activity with the aim of raising money for a charitable purpose. The second development occurred in Congress with the adoption of the unrelated business income tax in 1950,[146] with later revisions in 1969.[147] The institution of the unrelated business income tax allows the law to treat nonprofit charities like all other types of corporations to the extent that its activities are not mission-focused and produce income. Thus, with these two legal developments, the federal income tax exemption no longer applies to profits generated by a nonprofit charity if the *activities* generating these profits are not themselves charitable.[148]

As with many aspects of the charitable tax exemption, the basic idea of dealing with unfair commercial competition by eliminating the destination of income test and adopting the unrelated business income tax is surely efficiency-rationalized. Indeed, the addition of these legal rules to tax-exempt charity law advances the notion that only the income from *activity* that is charitable will be exempted from the federal income tax. However, beyond this basic idea, there are other issues to contend with concerning commercial competition that cannot be resolved by economic efficiency analysis alone. For instance, in the late 1990's the IRS had to decide whether and when to treat payments made to charities by charitable event sponsors as tax-exempt

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143. Treas. Reg. § 1.501(c)(3)-1(e)(1) (as amended in 1990).

144. *Id.*

145. *See* I.R.C. § 502(a) (denying § 501(a) exemption to feeder organizations).

146. *See* H.R. REP. No. 81-2319, at 36–37 (1950); S. REP. No. 81-2375, at 28–29 (1950), *reprinted in* 1950 U.S.C.C.A.N. 3053, 3081–83.

147. *See* H.R. REP. No. 91-413, at 46–48 (1969), *reprinted in* 1969 U.S.C.C.A.N. 1645, 1648–49; S. REP. No. 91-552, at 67–68 (1969), *reprinted in* 1969 U.S.C.C.A.N. 2027, 2032–33.

148. A tax is imposed on the unrelated business income of a tax-exempt organization. I.R.C. § 511. Unrelated business taxable income is any "gross income derived by an organization from any unrelated trade or business." *Id.* § 512. Unrelated trade or business is "any trade or business [that] is not substantially related . . . to the exercise or performance" of that organization's exempt purpose. *Id.* § 513.

revenues or as taxable unrelated business income tax revenues.[149] Many aspects of these corporate sponsorship issues were resolved not by economic analysis, but by other non-economic perspectives of law. Thus, as is the case with many aspects of law, economics can only go so far when it comes to a theoretical rationalization for the charitable tax exemption. This means that even economically motivated laws, such as tax law, could and should be understood not only in terms of economics, but also in terms of non-economic conceptions of justice and fairness. Part I of this article demonstrates more explicitly how economic analysis can be used with other theories of law to explain and shape law.

E. Private Foundations

Although many charities receive broad-based financial support from government and non-governmental entities, many other charities do not have such varied and wide-spread sources of financial support. When the financing sources for a charity are concentrated in one or very few people—people who might also have direct or indirect control over the charity—the potential for abuse of tax-exempt status is more likely to occur than if the sources of financial support and control are more widely dispersed. In recognition of this reality, Congress enacted rules in 1950 that denied tax exemption to charities that engaged in "prohibited transactions," unreasonably accumulated income, were used substantially for non-exempt purposes, or had invested money so as to jeopardize exempt purposes.[150] Congress exempted churches, schools and colleges, hospitals, and certain publicly supported organizations from these new rules.[151] These 1950 rules sparked the beginning of a distinction in tax-exempt charity law between "public" charities and "private" charities (private foundations) that continues today in a modified form.

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149. Tech. Adv. Mem. 91-47-007 (Nov. 22, 1991).

150. *See, e.g.*, Revenue Act of 1950, ch. 994, § 331, 64 Stat. 906, 957–59. The Revenue Act of 1950 denied income tax exemption to private foundations that "engaged in a prohibited transaction." *Id.* at 958. The term "prohibited transaction" was defined as including a transaction in which a charity "lends any part of its income or corpus," "pays any compensation, in excess of a reasonable allowance," "makes any part of its services available on a preferential basis," "makes any substantial purchase of securities . . . for more than adequate consideration," "sells any substantial part of its . . . property, for less than an adequate consideration" or "engages in any other transaction which results in a substantial diversion of its income or corpus"[] to "the creator;" substantial contributor; a family member of a creator or family member; or a corporation controlled by a creator. *Id.* at 957–58.

151. *See* S. REP. No. 81-2375, at 123–24 (1950), *reprinted in* 1950 U.S.C.C.A.N. 3053, 3081–83.

In 1954 and 1964, Congress made additional legislative changes to further distinguish so called "public" and "private" charities by providing for an increased ceiling on charitable contribution deductions for contributions to "public" charities.[152] These "public" charities included churches, schools, hospitals, and "publicly and governmentally supported" charities. Finally, in 1969, Congress again acted to stem the tide of potential abuses by "private" and so-called non-operating charitable foundations.[153] In that year, Congress eliminated the rules that denied charitable tax exemption to these troublesome charities and replaced those rules with new excise taxes that act as penalties for charities that engage in potentially abusive behavior, including self-dealing,[154] unreasonable income accumulations,[155] excess business holding,[156] risky investments,[157] and disfavored expenditures.[158]

The essential role of the private foundation rules is to control nonprofit corporations that express a desire to be mission-focused, but that lack a public mandate that would support the mission. For example, assume a wealthy individual has a family member who contracts a rare incurable disease. If neither the government nor any existing private organization is currently searching for a cure for that disease, the wealthy individual could either fund the research on her own, or she could donate the money to a self-created charity whose sole mission is to find a cure. While this self-created charity is most certainly mission-focused, the fact that neither the government nor any other private group is researching this disease indicates a lack of a public mandate for finding a cure. The lack of a public mandate, however, does not mean that the effort at finding a cure is not a proper charitable purpose. Nonetheless, the lack of widespread public involvement in this effort may lead to financial abuses of the self-created charitable corporation in terms of investments and the like. The private foundation rules are intended to hone in on the areas of potential abuse and, thereby, protect the charitable fisc. The heart of the private foundation rules is the definition of the term "private foundation."[159] A private foundation is a charitable corporation that lacks a

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152. *See* S. REP. NO. 83-1622, at 29–30 (1954), *reprinted in* 1954 U.S.C.C.A.N. 4623, 4660; S. REP. NO. 88-830, at 58–59 (1964), *reprinted in* 1964 U.S.C.C.A.N. 1673, 1730–33.

153. *See* I.R.C. §§ 4941–4945.

154. *Id.* § 4941.

155. *See id.* § 4942.

156. *Id.* § 4943.

157. *See id.* § 4944.

158. *See id.* § 4945.

159. *Id.* § 509(a).

wide array of public support[160] or public patrons.[161] Thus, the proxy for the public mandate is the presence of a wide array of financial support and supporters. In some cases, the charitable purposes themselves (e.g., churches, hospitals, and schools) serve as the proxy.[162]

The presence of the private foundation rules is consistent with contextual diversity because the rules permit all sorts of purposes to be advanced by tax-exempt charitable status—not only purposes that many people agree are of benefit to the public or are willing to fund, but also purposes that very few believe might benefit the public or are willing to fund. To demonstrate the benefit of private foundations, consider the example of the Howard Hughes Medical Institute—a private foundation that, at nearly $11 billion, is the second richest private foundation in the country.[163] The foundation originated from the personal fortune of one man, Howard Hughes, who created the foundation in the early 1950's as a personal tax shelter to protect his fortune. The stated purpose of the foundation is to do medical research. Although the foundation did no research for a number of years, its research efforts have since resulted in discovery of the genes responsible for cystic fibrosis and muscular dystrophy, a non-invasive test for colon cancer, and a drug that fights leukemia. More recently, the Howard Hughes Medical Institute has created new stem cell lines for future medical research—something that the federal government is prohibited from doing due to a Presidential directive.[164] Without this privately funded charity, these many valuable discoveries might not have occurred.

While diversity means that we have these opportunities for creativity that might not otherwise exist, they must be considered in context. Given the private nature of the funding source and the incentive for tax law abuse, the private foundation rules serve the governmental/public purpose of stemming the likelihood of tax abuse while still permitting the substantive charitable

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160. *See id.* § 509(a)(1).

161. *See id.* § 509(a)(2).

162. *See id.* § 170(b)(1)(A)(i)–(iii).

163. *60 Minutes: Howard Hughes Medical Institute* (CBS television broadcast, Nov. 23, 2003). Although the Howard Hughes Medical Institute is not technically a private foundation (it is a medical research institute as defined in § 170(b)(1)(a)(iii)), *see* DELOITTE & TOUCHE LLP, INDEPENDENT AUDITORS' REPORT 11 (2006), *available at* http://www.hhmi.org/about/pdf/HHMI2005AuditReport.pdf, the IRS treats it as a private foundation for some purposes. *See Faculty of Medicine Memorial Minute: George Widmer Thorn*, HARV. U. GAZETTE, Nov. 3, 2005, *available at* http://www.news.harvard.edu/gazette/2005/11.03/08-mm.html.

164. *See* The President's Radio Address, 37 PUB. PAPERS 33 (Aug. 20, 2001) (transcript available at http://www.whitehouse.gov/news/releases/2001/08/20010809-2.html) (limiting stem cell research to 60 existing stem cell lines).

functions to take place. Thus, the private foundation rules are a recognition of the fact that even private individuals can create great wealth and value for society. These rules are also a recognition of the fact that government, as a proxy for the public, has a strong interest in not allowing individuals to abuse the charitable tax exemption. In essence, the private foundation rules reflect the diverse ways in which public benefit might be "discovered." Diversity is a very important aspect of the charitable tax exemption. Contextual diversity is important because it recognizes the important role of diversity while also allowing charity tax law to mediate or modulate diversity in order to arrive at the right mix of public interests and private interests represented in the charitable tax exemption. This mediating aspect of the charitable tax exemption must accommodate a variety of value interests—both economic and non-economic value interests. Part I of this article explains in greater detail how economic values can be effectively combined with other non-economic values to form a more complete theoretical understanding of law and, potentially, aid in better refining law in the future.

IV. EFFICIENCY THEORIES OF CHARITABLE EXEMPTION

Traditional theories of the charitable tax exemption—at least those promulgated prior to 1990—are principally based on concepts of economic efficiency. These efficiency-based theories explain the charitable tax exemption as either a subsidy by government for public goods,[165] a necessary result of using net income to define tax liability,[166] or a means of compensating charities for capital constraints.[167] Other efficiency-based theories contend that the charitable tax exemption is either a payment for an entity's ability to garner donative support[168] or a means of compensating charities for the risk they assume in providing public goods.[169] Each of these economic theories for the charitable tax exemption has its strengths and its weaknesses. In terms of explaining the economics for why charities are tax-exempt, these traditional theories do a pretty good job. These theories are also somewhat useful in sculpting the contours of the charitable tax exemption.

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165. *See* Bob Jones Univ. v. United States, 461 U.S. 574, 577 (1983); H.R. REP. NO. 75-1860, at 19 (1938).

166. Bittker & Rahdert, *supra* note 2, at 302–03.

167. Hansmann, *supra* note 3, at 55.

168. *See* Hall & Colombo, *Charitable Status*, *supra* note 3, *passim*; Hall & Colombo, *Donative Theory*, *supra* note 3, *passim*.

169. *See* Crimm, *supra* note 3, *passim*.

However, these traditional theories lack significant non-economic components which, ultimately, makes them incomplete. These economic theories for the charitable tax exemption do not explain the existence of the many non-economic aspects of the exemption. This explanatory deficiency also means that these efficiency theories cannot *fully* guide us in sculpting the contours of charitable tax exemption law.

A. Public Benefit Subsidy Theory

The first of the efficiency based theories of charitable tax exemption is the public benefit subsidy theory. The public benefit subsidy theory posits that the charitable tax exemption is a means by which government encourages organizations engaged in providing public goods to continue to do so. The most notable proponent of this theory has been the government itself. For example, in *Bob Jones University v. United States*, the Supreme Court notes the following:

> Charitable exemptions are justified on the basis that the exempt entity confers a public benefit—a benefit which the society or the community may not itself choose or be able to provide, or which supplements and advances the work of public institutions already supported by tax revenues. History buttresses logic to make clear that, to warrant exemption under § 501(c)(3), an institution must fall within a category specified in that section and must demonstrably serve and be in harmony with the public interest. The institution's purpose must not be so at odds with the common community conscience as to undermine any public benefit that might otherwise be conferred.[170]

In addition to the government, scholars have also advocated this public benefit subsidy theory for the charitable tax exemption. An essential aspect of the theory is that government subsidizes certain "goods" or services that government either cannot or will not supply on its own. The reasons for government failure to supply these particular goods or services vary. For instance, government could have constitutional constraints—as is the case with religion—that prevent government from supplying the good. Government might also have political constraints, such as the requirement for majority political support, that prevent it from supplying the good. Thus, the point of the charitable tax exemption—according to the public benefit subsidy theory—is to permit government to essentially "pay" or "compensate" private entities that supply these public goods and services.

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170. *Bob Jones Univ.*, 461 U.S. at 591–92.

An implicit assumption underlying the public benefit subsidy theory is the idea that government, under neutral principles, can determine what constitutes a public good or service.[171] Hence, elements of the rational market participant—reminiscent of economic analysis—pervade this theory of charitable tax exemption. Also of economic dimension is the idea implicit in the public benefit subsidy theory that the government is somehow *paying* charities for what they produce.[172] Given these economic dimensions, the traditional public benefit subsidy theory partially rationalizes many aspects of the charitable tax exemption. That is, the exemption truly is a form of financial support for charities—at least in some cases. Further, the government does play a role in deciding what goods and services actually benefit the public for purposes of the charitable tax exemption. Nevertheless, there is much about the charitable tax exemption that the traditional subsidy theory does not address.

For all of its great virtues, the public benefit subsidy theory does not address why this government financial support for charities must take the form of a tax exemption. For instance, why not simply have the government make direct grants to nonprofit corporations that provide goods and services that benefit the public? The public benefit subsidy theory also does not articulate a coherent rationale for how the decision is made as to what goods and services benefit the public. The theory's silence on this point seems to indicate that neutral market principles might drive the process of deciding what benefits the public. However, this is not necessarily so. In *Bob Jones University*, the private university that was the subject of that case provided what was identified in the charitable tax exemption statute as a public benefit—education; yet the Court held that the education in that case was not entitled to exemption due to the presence of invidious racial discrimination.[173]

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171. *See* Atkinson, *Altruism*, *supra* note 3, at 606.

172.

> The exemption from taxation of money or property devoted to charitable and other purposes is based upon the theory that the Government is compensated for the loss of revenue by its relief from financial burdens which would otherwise have to be met by appropriations from other public funds, and by the benefits resulting from the promotion of the general welfare.

Bob Jones Univ., 461 U.S. at 590 (quoting H.R. REP. NO. 75-1860, at 19 (1938)).

173. Justice Powell, though he agreed with the majority's ultimate holding that charities could not maintain tax exemption if they engage in invidious racial discrimination, questioned the broad majoritarian nature of the majority's adoption of the public policy doctrine to address this specific racial subordination problem: "Nor am I prepared to say that petitioners, because of their racially discriminatory policies, necessarily contribute nothing of benefit to the community. It is clear from the substantially secular character of the curricula and degrees offered that petitioners provide educational benefits." *Id.* at 609 (Powell, J., concurring).

Efficiency analysis alone, arguably, does not provide a rationalization for this aspect of charitable tax exemption. Hence, the public benefit subsidy theory's reliance on "neutral" efficiency principles simply does not provide a basis for understanding how a public benefit is determined.

B. Base-Defining Theory

Recognizing deficiencies in the public benefit subsidy theory, Boris Bittker and George Rahdert developed a theory of charitable tax exemption that also focused explicitly on the economic aspects of the exemption. Bittker and Rahdert's base-defining theory posits, essentially, that charities (and many other nonprofits) are exempt from the federal income tax because they are not suitable targets of the income tax.[174] Specifically, Bittker and Rahdert state that:

> . . . [Charities] should be wholly exempted from income taxation, because [(1)] they do not realize "income" in the ordinary sense of that term and because, [(2)] even if they did, there is no satisfactory way to fit the tax rate to the ability of the beneficiaries to pay.[175]

Thus, according to Bittker and Rahdert, charities are exempt from the income tax by necessity.

In support of their theory, Bittker and Rahdert explain that measuring the income of a charity is a conceptually difficult, if not impossible, task.[176] To begin with, measuring an entity's income requires a determination of the entity's gross income in excess of expenses incurred in acquiring the income.[177] Gross income is generally any economic enrichment that is not excluded from income by Congress.[178] One common Congressional exclusion from income is gifts.[179] Thus, money or property given with "detached and disinterested generosity" is not usually treated as taxable income.[180] In looking at what a charity's typical revenues might be (interest on endowment funds, membership dues, gifts/donations), Bittker and Rahdert conclude that, with the exception of interest on endowment funds, charities simply do not produce revenues that represent the types of enrichments that constitute

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174. *See* Bittker & Rahdert, *supra* note 2, at 304.
175. *Id.* at 305.
176. *Id.* at 307–14.
177. *See* I.R.C. § 63(a) (defining "taxable income").
178. *Id.* § 61(a); Comm'r v. Glenshaw Glass Co., 348 U.S. 426, 429–31 (1955).
179. I.R.C. § 102(a).
180. *See* Comm'r v. Duberstein, 363 U.S. 278, 285 (1960).

taxable income.[181] Bittker and Rahdert explain this conclusion from two perspectives. On the one hand, membership dues, gifts, and donations to the charity would likely be viewed as excludable gifts from members/donors to the charitable entity. Even if not viewed as gifts to the institution, these charitable revenues might be viewed as excludable gifts to the charity's beneficiaries—the charitable entity itself acting as a mere conduit for passing the revenues to beneficiaries.

In addressing the expense side of the net income equation, Bittker and Rahdert explain that, even if one were to properly conclude that charitable revenues constituted gross income, a separate difficulty involves determining what to count as deductible expenses incurred in acquiring the income.[182] Bittker and Rahdert identified charitable expenditures as potentially including items such as staff salaries and medical welfare programs for indigents. One way of deducting an expense is by positioning it as an "ordinary and necessary expense incurred in carrying on a trade or business" activity.[183] Bittker and Rahdert explain, however, that treating charitable activity as a "trade or business" is self-contradictory because, unlike for-profit enterprises, charities are mission-focused, not profit-focused. Additionally, even if the definition of "business" were expanded to include the business of providing charitable benefits, a charity would essentially end up having no tax liability because, as a result of the non-distribution constraint, all revenues must be devoted to mission purposes and no revenues may go as profits to insiders. Thus, net income—save for some instances of multi-year accumulations for specific purposes—would always equal zero, resulting in no tax liability. Another way of deducting expenses is by positioning the expense as eligible for the charitable contribution deduction.[184] However, Bittker and Rahdert explain that, as with the business expense scenario described above, either structural impediments in the statute authorizing the charitable deduction or the necessary zeroing out of income that would result from allowing the deduction indicate that charities should not be permitted to take a charitable contribution deduction for charitable expenses.

In addition to the income measurement problems associated with imposing an income tax on charities, Bittker and Rahdert also raise concerns about the appropriate tax rate to apply to charities—further supporting their

181. Bittker & Rahdert, *supra* note 2, at 307–09.
182. *Id.* at 309–14.
183. I.R.C. § 162(a).
184. *See id.* § 170(a).

base-defining rationale for the charitable tax exemption.[185] According to Bittker and Rahdert, tax rates are important because they implicate conceptions of efficiency related to either the "benefit" or "ability to pay" theories of taxation.[186] The idea here is that tax law generally attempts to match tax burden with the taxpayer's circumstances. Bittker and Rahdert argue that a charity's income should be imputed to its beneficiaries for rate determination purposes since it is most likely the beneficiary who would bear the burden of any tax on the charity's income. The problem, Bittker and Rahdert explain, is that the beneficiaries are usually unknown at the time the income is received and, thus, it is nearly impossible to determine an appropriate income tax rate. Even if the entity were taxed as a surrogate for the beneficiaries, Bittker and Rahdert explain that not knowing who the beneficiaries are would *necessarily* mean that a tax on income would be inefficient—potentially over-taxing some beneficiaries and under-taxing others. Bittker and Rahdert further explain that, aside from the identification-of-beneficiary aspect of the rate issue, another point is that these beneficiaries—were they to receive these charitable benefits directly—would be able to exclude them from income as excludable gifts.[187] Thus, however the matter is approached, Bittker and Rahdert conclude that there is simply no way of coming up with a proper tax rate if charities were to be subject to the income tax.

As an economic explanation of the charitable tax exemption, Bittker and Rahdert's base-defining theory does a good job of demonstrating that, for the most part, imposing an income tax on charities would likely not yield much in the way of federal income tax revenues. However, the thesis of this article is premised on the notion that there is more to the charitable tax exemption than just the elimination of a financial obligation of charities to pay tax on income—however that term is defined.[188] Indeed, the charitable tax exemption is about justice and fairness in resource allocation; it is about providing and creating opportunities for societal enhancement and betterment where none would exist otherwise. Thus, Bittker and Rahdert's theory, even if taken at face value, fails to fully explain the many non-economic aspects of the charitable tax exemption. More precisely, some of the aspects of the charitable tax exemption that Bittker and Rahdert's theory fails to address

185. Bittker & Rahdert, *supra* note 2, at 314–16.

186. *Id.* at 315 (citing R. MUSGRAVE & P. MUSGRAVE, PUBLIC FINANCE IN THEORY AND PRACTICE 192–204 (1973)).

187. *See* I.R.C. § 102(a).

188. *See supra* Part III.

include the difference between a zero or near-zero tax liability and tax exemption,[189] political activities and lobbying,[190] the definition of "charitable," and private foundation rules.

Throughout their base-defining theory, Bittker and Rahdert explain that, even if the federal income tax were to apply to a charity's income, it is quite likely that no tax revenue would result.[191] Reminiscent of this view is the statement that "[t]ax immunity would then have been achieved, but by a more roundabout route than the straightforward exemption. . . ."[192] This view of the charitable tax exemption as nothing more than elimination of a financial obligation, completely overlooks the many other non-economic aspects of the charitable tax exemption. As Evelyn Brody explains quite well in her sovereignty theory of charitable tax exemption:

> While most observers have described tax exemption as a subsidy, a zero rate of tax differs qualitatively, not just quantitatively, from a one-percent rate of tax. Tax exemption maintains an independent distance between charities and the state. Similarly, exemption differs in an important political way from an equivalent system of direct grants.[193]

Thus, in Brody's words, there is a "qualitative[]" dimension to the charitable tax exemption that is not captured by a pure dollars and cents analysis. This qualitative difference is what lies at the heart of the normative justification for the exemption.

As previously explained, central to the charitable tax exemption is defining the term "charitable."[194] Though Bittker and Rahdert address the issue of what constitutes "charitable," they fail to fully develop the non-economic aspects of their theory as it relates to the meaning of "charitable."[195] For instance, when addressing the relevance of racial discrimination to the concept of "charitable," Bittker and Rahdert explicitly minimize the importance of this relevance by referring to the race issue as a "minor problem[] of interpretation."[196] Granted, Bittker and Rahdert drafted their base-defining theory in 1976, well before the all-important *Bob Jones University* case was decided in 1983.[197] However, even in 1976 the

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189. *See* Bittker & Rahdert, *supra* note 2, at 313.
190. *See id.* at 305, 334.
191. *See id.* at 313.
192. *Id.*
193. Brody, *supra* note 3, at 592–93.
194. *See supra* Part III.
195. Bittker & Rahdert, *supra* note 2, at 330–36.
196. *Id.* at 331.
197. See Bob Jones Univ. v. United States, 461 U.S. 574 (1983).

predominant view was that racial discrimination rendered some purposes non-charitable because of racial discrimination's inconsistency with federal public policy.[198] The other "minor problem[] of interpretation" issue identified by Bittker and Rahdert also involved an issue of paramount importance to people of color: whether charities have an obligation to provide free or reduced cost services to those who are unable to pay in a variety of contexts.[199] Could a critical race perspective add to our understanding of this aspect of the charitable tax exemption?

What's important here is that Bittker and Rahdert's base-defining theory fails to explain this and other non-economic aspects of the term "charitable." Instead of recognizing this as a limitation of their base-defining theory, Bittker and Rahdert choose to minimize the non-economic issues as "minor." Importantly, it is not only in the context of race, or even with regard to defining charitable, that Bittker and Rahdert must account for various aspects of the charitable tax exemption in some non-economic way. For example, with regard to private foundations, Bittker and Rahdert's base-defining theory could not rationalize why the various private foundation excise taxes exist.[200] Thus, the architects of the base-defining theory resort to a type of contextual diversity as a means of rationalizing these special penalty taxes. In rationalizing the private foundation excise tax rules, Bittker and Rahdert state that:

> Private organizations displaying independence, flexibility, and originality are bound to tread on toes, and when the toes belong to public officials, an adverse legislative reaction should not come as a surprise."[201]

Rationalizing the private foundation excise taxes as a type of penalty imposed for contravening government "territory" or "authority" seems consistent with this article's notion of contextual diversity. That is, law and market economy theory states that market participants are constantly seeking to gain authoritative control in the marketplace.[202]

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198. *See* E. Ky. Welfare Rights Org. v. Simon, 426 U.S. 26, 30 (1976); Green v. Connally, 330 F. Supp. 1150 (D.D.C. 1971); Rev. Rul. 71-447, 1971-2 C.B. 230; Rev. Rul. 75-231, 1975-1 C.B. 158.

199. *See* Bittker & Rahdert, *supra* note 2, at 331 n.82; *see also Simon*, 426 U.S. at 30; Rev. Rul. 74-587, 1974-2 C.B. 162 (lender to "ghetto" businesses); Rev. Rul. 75-75, 1975-1 C.B. 154 (public interest law firms).

200. *See* Bittker & Rahdert, *supra* note 2, at 336–42.

201. *Id.* at 342.

202. *See* MALLOY, *supra* note 14, *passim.*

Bittker and Rahdert's base-defining theory uses a similar type of non base-defining (non-economic) analysis to fully account for the educational exemption for museums, colleges, and orchestras.[203] Because their beneficiaries are not necessarily poor, as is the case with many other types of charities, the improper rate aspect of the base-defining theory does not account for these particular types of "educational" institutions.[204] So, instead of relying exclusively on base-defining/economic concepts to explain these upper echelon charities, Bittker and Rahdert again resort to a type of contextual diversity analysis. Accordingly, Bittker and Rahdert rationalize that the benefits of "educational" institutions extend beyond the immediate beneficiaries to "an indefinably wide audience over the entire income spectrum."[205] Additionally, they explain:

> [I]t is precisely in the area of education, including the arts, that private institutions are especially well suited to serve as independent centers of power and influence in our society, fostering innovation and diversity with a dedication that government agencies can seldom muster or sustain. This separate rationale for tax exemption applies particularly to educational institutions."[206]

Thus, when economics fails to explain some important and varied aspects of the charitable tax exemption, Bittker and Rahdert resort to notions of "diversity" and "context" to fill in the theoretical gaps.

C. Capital Formation Subsidy Theory

Five years after publication of Bittker and Rahdert's base-defining theory of charitable tax exemption, Professor Henry Hansmann published his own theory of charitable tax exemption[207] which responds, in explicit economic

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203. *See* Bittker & Rahdert, *supra* note 2, at 334–35.

204. *Id.* As Bittker and Rahdert explain:

> The rationale for exempting educational institutions from income taxes is substantially the same as that for exempting other charitable organizations. The principal difference, which is one of degree rather than of kind, is that the students who attend exempt schools and colleges and the patrons of museums, galleries, and orchestras probably come from higher income classes than most of the beneficiaries of other charitable organizations. Though this does not make it any easier to compute the "net income" of educational organizations, it weakens one argument in favor of exempting many other nonprofit organizations—that the burden of a tax would fall largely on persons at the bottom of the income ladder.

Id. at 334.

205. *Id.*

206. *Id.* at 335.

207. Actually, Professor Hansmann's theory is a theory of the exemption of nonprofits generally—

terms,[208] to Bittker and Rahdert's approach.[209] In his capital formation subsidy theory of tax exemption, Professor Hansmann explains that the rationale for the charitable tax exemption concerns the access of charities to capital markets. As Professor Hansmann explains:

> [T]he best justification for the exemption is that it helps to compensate for the constraints on capital formation that nonprofits commonly face, and that such compensation can serve a useful purpose, at least for those classes of nonprofits that operate in industries in which, for various reasons, nonprofit firms are likely to serve consumers better than would profit-seeking firms.[210]

Thus, for Professor Hansmann, the tax exemption compensates charities for the lack of access to capital markets. Further, Professor Hansmann explains, this so-called "capital subsidy" promotes "efficiency when employed in those industries in which nonprofit firms serve consumers better than their for-profit counterparts."[211]

Central to Professor Hansmann's capital subsidy theory is the notion of contract failure. For Professor Hansmann, contract failure is a type of market failure that "derives from the inability of some or most consumers to make accurate judgments concerning the quality, quantity, or price of services provided by alternative producers."[212] Contract failure, according to Professor Hansmann, is most prevalent with what he terms donative nonprofits (nonprofits that receive revenues mostly through donations) as opposed to commercial nonprofits (nonprofits that receive revenues mostly through commercial sales activities). Professor Hansmann's classic example of a donative nonprofit that typifies contract failure is the American Red Cross.[213] A person making a contribution to Red Cross is in essence buying disaster relief services from the Red Cross for some unknown third party. This is a circumstance of contract failure because the consumer/donor must blindly rely on Red Cross to determine who gets disaster relief, how much they get, and

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both charitable and non-charitable nonprofits. Hansmann, *supra* note 3, at 57 (referring to all tax exemptions listed in I.R.C. § 501(c), not just I.R.C. § 501(c)(3)). But since his theory includes the charitable tax exemption in its scope, this article will refer to it as a theory of charitable tax exemption.

208. *Id.* at 56 ("Much of the discussion in this Article is presented in economic terms, as is appropriate for the subject at hand.").

209. In fact, Professor Hansmann refers to Bittker and Rahdert's base defining theory as "[t]he most comprehensive and thoughtful of the[] efforts" to rationalize the charitable tax exemption. *Id.* at 54–55.

210. *Id.* at 55.

211. *Id.* at 72.

212. *Id.* at 67–68.

213. *Id.* at 61.

under what terms they get it. Nonprofit firms are more efficient, for Professor Hansmann, than for-profit firms in providing these types of contract failure services because of the nondistribution constraint. That is, consumers are not as concerned with nonprofit firms as they would be with for-profit firms about donations being diverted to shareholders because nonprofit firms do not have shareholders. Thus, for Professor Hansmann, (donative) nonprofit firms are more efficient than for-profit firms in circumstances of contract failure.[214]

In addition to contract failure, Professor Hansmann also points to constraints on the ability of nonprofits to obtain capital as another important component explaining the income tax exemption. The three major sources of funding for nonprofits are debt, donations, and retained earnings.[215] Notably, because nonprofits cannot issue shares, they do not have access to equity capital, as is the case with for-profit firms. Professor Hansmann explains that debt capital is difficult for nonprofits to obtain because of the risk involved in loaning to nonprofits. Donations are also problematic because donations are uncertain and inadequate. Thus, according to Professor Hansmann, nonprofits must rely almost exclusively on retained earnings in order to finance growth. While this fact alone—restraints on access to capital markets—does not justify the tax exemption, Professor Hansmann argues that coupling this restraint with the fact that many nonprofits operate under circumstances of contract failure, means that the exemption is needed. For Professor Hansmann, if we want markets to operate at optimal efficiency, and if we accept that nonprofits are the most efficient producers of contract failure goods/services, then it makes sense that we subsidize nonprofits in order to increase the rate at which nonprofits can expand.[216]

Although Professor Hansmann's capital formation subsidy theory articulates a clear rationale for why the charitable tax exemption is efficient, it does not articulate a clear basis for understanding aspects of the exemption that have no necessary connection to economic efficiency. Professor Hansmann's deficiency is most apparent in his conclusion that the tax exemption should be sculpted so as to deny the exemption to many commercial nonprofits that produce simple standardized services, as opposed

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214. According to Professor Hansmann, two efficiency advantages of donative nonprofits include (1) a reduction in the efforts that consumers feel impelled to make to police the provider of a service when the provider is nonprofit rather than for-profit, [and] (2) a reduction in the disparity between cost and price occasioned by the elimination of the excessive profits that for-profit producers might be able to secure . . . .

Id. at 70 n.57.

215. *Id.* at 72–75.

216. *Id.* at 74–75.

to complex services.[217] Typical of Professor Hansmann's view is the statement that "[t]here would obviously be little point . . . in granting the exemption to a nonprofit hardware store."[218] What Professor Hansmann misses here is the point that even a hardware store might provide the type of benefit, under certain circumstances, that society wants, needs, or otherwise values. For example, what if that hardware store only employed people who are handicapped or blind? What if this hardware store provided an employment opportunity to racial minority groups or others who would not otherwise have employment? If for-profit firms choose not to open a hardware store that employs these populations, these people might be jobless or dependents of government. Thus, even though the hardware store might not operate under conditions of classic contract failure, and even though it might not be economically efficient to operate a hardware store by employing these populations, it is still of *real value* to society that this hardware store operate. To the extent that granting tax exemption allows this to happen, then society is all the better for it.

Another example of Professor Hansmann's theory's disconnect from the aspects of the charitable tax exemption that are not susceptible to efficiency analysis is the assertion that nonprofit hospitals should not be eligible for tax exemption. Professor Hansmann's articulated reason for this assertion is the lack of contract failure or need for capital evident in the hospital industry.[219]

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217. *Id.* at 86–89. Professor Hansmann explains:

> Between these two extremes—donative nonprofits on the one hand, and commercial nonprofits that provide simple standardized services on the other—we have the troublesome category of commercial nonprofits that provide complex personal services such as education, hospital care, nursing care, and day care. For which, if any, of these services are the fiduciary qualities of the nonprofit form so effective and necessary that tax exemption can be justified on efficiency grounds? It is difficult to offer an authoritative answer to this question, since at present there exist little solid data concerning the relative performance of nonprofit and for-profit firms in providing such services.

Id. at 88.

218. *Id.* at 87.

219. Professor Hansmann explains:

> On the other hand, it is not at all clear that there is justification for the relatively recent decision to exempt nonprofit hospitals from taxation even if they provide no research, teaching, or subsidized care for indigents; that is, even if they are operated as strictly commercial nonprofits. Problems of contract failure do not seem important in the case of most hospital services. *The continued predominance of the nonprofit form in this industry seems, instead, to be attributable to historical and financial factors largely unrelated to the relative efficiency of for-profit and nonprofit institutions.* Moreover, there is evidence that, in general, the hospital industry is already overcapitalized. Thus, the hospital industry arguably fails both the criteria suggested above for administering the exemption. The current policy of exempting virtually all nonprofit hospitals may simply further encourage what already appears to be excessive capital investment in this sector.

It is important to realize—and this is a point that Professor Hansmann and many others miss—that the *value* inherent in a particular form of charitable organization may not be readily apparent by means of traditional efficiency analysis. To illustrate, consider Professor Jill Horwitz's empirical research concerning hospitals. Professor Horwitz concludes that—despite the myriad of calls for ending tax exemption for hospitals that do not serve the poor—empirical research shows that tax-exempt nonprofit hospitals provide societal benefits that for-profit hospitals simply do not provide.[220] The special benefits of nonprofit, as compared to for-profit and government hospitals include the provision of "more profitable services than government hospitals and more unprofitable services than for-profit hospitals."[221] Though Professor Horwitz does not conclude that these unique benefits of tax exempt nonprofit hospitals are caused by tax exemption, she does acknowledge that this connection has not been disproven.[222] Importantly, Professor Horwitz, consistent with this article's theory of contextual diversity, suggests that "[t]he near exclusive

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Id. (emphasis added).

220. Professor Horwitz explains:

> The legal categories of corporate form matter a great deal. I present new empirical work showing that corporate form explains important differences in hospital behavior. I argue that not-for-profit firms very likely provide public and private goods that are both in the public interest, which for-profit firms fail to provide. By looking at only traditional measures of charitable behavior such as subsidized care for the poor, legal scholars have overlooked distinctions among ownership types. Instead, by examining the central function of hospitals—providing medical care—I find large differences among corporate forms, and argue that these imply large differences in hospital goals. Relying on this empirical work, I recommend that at least some hospitals in a market should be not-for-profit. We do not know enough to conclude which type of hospital or mix of types in a market is best. For the time being, we should assume that markets consisting of either entirely for-profit or government hospitals would not serve the public interest.

Horwitz, *supra* note 42, at 1347.

221. *Id.* at 1367. Professor Horwitz explains:

> This part reports and interprets new evidence that comparable hospitals of different types—not-for-profit, for-profit, and government—offer different types of medical services. The findings imply that they implement different organizational goals. Although specifying these goals is difficult, the evidence supports the theory that government hospitals are hospitals of last resort. They are more likely than both other types to offer unprofitable services that are generally needed by poor, underinsured patients. For-profits seek profits and avoid offering unprofitable services more than the others. Not-for-profit hospitals are the intermediate type—while they are less responsive to financial incentives than are for-profits (both in offering profitable and avoiding unprofitable services), they are also less likely than similar government hospitals to offer unprofitable, undersupplied services. These results belie predictions that not-for-profit hospitals will behave no differently than for-profit hospitals in the production of public goods when under financial pressure.

Id. at 1364.

222. *See id.* ("Whether the tax exemption causes the differences . . . remains an open question . . . . [I]f the exemption is causing desirable not-for-profit behavior, then the costs of eliminating it may be high.").

focus on charity care as an acceptable justification for tax exemption is too narrow. Tax policy should reflect the other important public benefits disproportionately provided by not-for-profit hospitals."[223]

V. POTENTIAL IMPLICATIONS FOR THE STRUCTURE OF TAX EXEMPT CHARITY LAW

The analysis of the charitable tax exemption contained in this article has several very important potential implications for the structure of tax-exempt charity law. In general, these implications center around the idea that the parameters of tax-exempt charity law, though not endless, are at times unknown. While we can continuously re-evaluate what does and does not provide benefits to society and hence is entitled to tax-exempt charitable status, we must be careful when proscribing particular functions as categorically non-deserving of charitable status. The reason for this hesitancy is that we simply never know what new and different *value* might be produced. A new perspective on an old activity may indeed be worthwhile. But we may never realize that value if we foreclose it categorically. This might be problematic, in some regard, for lawmakers and judges—for they necessarily have to draw lines and decide what is permissible and what is not. However, it is important to always recognize that those lines are not immoveable or static. Instead, the lines should be fluid and drawn from a variety of perspectives.

Similarly, the analysis in this article also suggests that efficiency not be the only guide for how tax-exempt charity law is crafted. Instead, we should draw on lessons from LMT theory that it takes many perspectives in order to obtain a clearer picture of the meaning ascribed to particular interpretations of the relationship among law, markets, and culture. Thus, to the extent that we can draw on other than positive economic visions of law to make decisions about tax-exempt charity law, we do so to our benefit. Accordingly, we should identify worthy and appropriate values for law and then think about the best way to approach and implement these values in a market context. Using this line of reasoning, it is perfectly appropriate that CRT be used as a basis for gaining a better understanding of the public policy doctrine. The public policy doctrine emerged from a circumstance of racial discord. However, the policy adopted by the Supreme Court in *Bob Jones University* is devoid of racial components. Furthermore, no court since the Supreme Court in *Bob*

223. *Id.* at 1349.

Jones University has applied the public policy doctrine in any circumstance aside from racial discrimination. Given this state of affairs, contextual diversity would suggest that the public policy doctrine be invalidated and, instead, charities be explicitly prohibited from engaging in invidious racial discrimination. A nuanced interpretation of this particular conclusion would suggest that affirmative action, even if race-based, not be prohibited by this re-cast anti-discrimination rule.

CONCLUSION

Law involves a process of interpretation, and interpretation is socially situated. Tax law is no different. Although tax law is often represented by quantitative analysis in terms of its impact, this should not obscure the non-quantitative and interpretive aspects of tax law. Tax-exempt charity law, and it allegiance to "mission" as opposed to "profit," is a perfect vehicle for exploring the non-efficiency based aspects of tax law. This article takes part in such analysis by articulating what is termed a "contextual diversity" theory of the charitable tax exemption. Contextual diversity requires that various aspects of the charitable tax exemption be examined, not only with the aim of maximizing efficiency, but also with the broader aim of advancing conceptions of justice that go beyond positive economic analysis to include fairness and other ideas important to a democratic society. Thus, in addition to using economic analysis to examine tax-exempt charity law, scholars and others could possibly discover more diverse and different meanings in tax-exempt charity law by drawing on appropriate non-economic legal approaches to law, such as CRT or others. This intellectual collaboration could not only broaden the discourse about the charitable tax exemption, it could potentially lead to discoveries about this area of law that we never knew existed. Thus, instead of thinking of the charitable tax exemption as simply an efficient means of providing certain goods and services to the public, our horizons might be broadened by thinking of the exemption in a different way. That is, we could think of the charitable tax exemption as a means of diversifying the market and, thus, allowing for more creative and wealth-producing opportunities. However, the charitable tax exemption is also subject to contextual constraints that act to limit the scope of charitable activity. In the end, the objective should be justice, not just efficiency.